

VIS

Credit Rating Company Limited

SECURITIES FIRMS

Table of Contents

INDUSTRY DYNAMICS AND REGULATORY FRAMEWORK.....	3
STRATEGY / FRANCHISE STRENGTH	4
MANAGEMENT	4
RISK ADMINISTRATION & CONTROLS.....	4
PERFORMANCE.....	5
SPONSORS STRENGTH, CAPITALIZATION AND LIQUIDITY	6
RATING SCALE & DEFINITIONS	6



VIS Credit Rating Co. Ltd.'s (VIS) rating objective for a securities firm is to assess likelihood of the company being able to make timely payment against its obligations. A rating being prospective in nature, VIS integrates analysis of an entity's recent financial and operating performance with an assessment of the firm's strategic plan. The focus is on evaluating the quality of a firm's balance sheet, the appropriateness of its liquidity and capital funding policies, and the effectiveness of its risk management strategies with regards to various financial and operational risks.

VIS reviews the quality of the firm's financials, its franchise, its ability to attract adequate funding and generate profitable returns through market cycles. This review is central to the rating process and is supported by consistent monitoring of industry dynamics and competitive forces.

In undertaking its rating assessment, VIS is reliant on acceptable quality work being done by other independent third parties. In addition to financial audit, securities firms are required to undergo systems audit, and audit by the Central Depository Company Limited (CDC); the results of these various external evaluations provide basis for the veracity of reported financial numbers and the robustness of the internal structure set in place. The strengthening of the reporting requirements at regulatory level for the securities firms has added to the moderation of risk profile of the Stock exchange and the players within it. Level of adoption of international guidelines on conflict of interest and code of ethics will also be evaluated to gauge a firm's adherence to best practices. 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.

INDUSTRY DYNAMICS AND REGULATORY FRAMEWORK

Securities firms are involved in a highly competitive industry in which trading activity can be greatly impacted by interest rates and economic cycles. The industry can also be significantly affected by event risk, particularly resulting from regulatory or political developments. Such factors can lead to greater volatility in earnings and profitability relative to other industry sectors. Generally, securities firms serve the basic function of distributing and trading financial instruments for customers, arranging for financing customer positions, and providing advisory and underwriting services. The importance of these functions to a given economy, the size of the customer base, and the availability of substitute products or alternative suppliers will affect the approach to a rating.

Prior to 2012, the stock exchanges were operating as non-profit organizations with a mutualized structure. Under this structure, stock exchanges comprised members who had both trading and ownership privileges. However, when the Stock Exchanges (Corporatization, Demutualization & Integration) Act, 2012 ("Demutualization Act") was promulgated by the Government, 'Members' of stock exchanges ceased to exist. Instead, they have been issued Trading Right Entitlement Certificates ("TRECs") and exchange shares, thus separating trading rights from ownership rights. This elimination of conflict of interest and the inclusion of international investors in PSX has given it the international color. All securities firms have to be TREC-holders of Pakistan Stock Exchange (PSX) and have the choice of opting for any of the three regimes of licenses; trading only, trading and self clearing and trading and clearing, depending upon the fulfillment of regulatory conditions assigned to each type of license. The stock exchanges are regulated by the Securities & Exchange Commission of Pakistan (SECP).

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. VIS reviews regulations that promote money and capital markets through regulation of stock-trading commissions or other transaction costs and taxes, and examines policies & procedures. These rules and regulations provide creditors

protection through minimum capital, exposure limit and margin requirements. In addition to these, the company's efforts at prudent risk control in accordance with its business lines are also analyzed.

In April 2020, SECP imposed an upward revision in the minimum capital requirements for brokerage firms. This increase in minimum capital requirements, will impact the structure of the brokerage industry, and in turn, impact the standalone performance of brokerage companies. VIS will accordingly assess the impact of such regulatory changes on the financial and business risk profile of rated entities.

STRATEGY / FRANCHISE STRENGTH

While developing an understanding of the management's business strategy, VIS evaluates its competitive positioning and niche, and the viability of the company to operate in that niche and at the same time grow its business volumes. A lot depends on the company's ability to adapt to the changing needs of its clientele and offer innovative services & products which are consistent with the changing dynamics of the industry and market. Services could include convenience of online customer trading/account status or other pertinent information, and ancillary products could include research reports and other publications, which provide value addition to the basic trading facilities offered by any firm. Market share and trends on business & client growth are effective tools to gauge the company's franchise.

VIS also reviews the responsiveness of the company towards globalization of its trade and increasing the trend towards foreign portfolio investment.. The company's ability to handle inward foreign investments in capital markets in a costeffective manner is a valuable diversification in revenue sources while adding to the franchise of the firm. Depending on the firm's business, VIS examines the size of marketing force, customer profile, customer retention & growth, and average turnover in trading activity

MANAGEMENT

Success of any organization is in the continuity of its business strategies and depth & stability in its management team. A view on the corporate structure is developed. This area also involves reviews of managerial involvement in risk control, its ability to innovate, focus of management on core competencies and the management's flexibility in responding to competition. Importance given to planning & implementation processes, and the decision-making hierarchy also provide insight into the level of controls in place in the company and the confidence in the management team itself. Training and development of employees to assimilate them with the ongoing changes in market place and regulatory changes is also considered. Per employee revenues and costs would help determine management efficiency and economic utilization of resources. Management expertise should pertinently be reflected in the financial performance of the company. Alongside, VIS also assesses the legal structure of the entity which can vary across private limited, public limited, sole proprietorships and partnerships. Each legal structure has a different implication for the governance, management, and overall financial risk profile of the rated entity.

RISK ADMINISTRATION & CONTROLS

Broad parameters of risk include price and interest rate risk, credit / counter party risk and operational risk. A company's vulnerability to these risk factors may be measured by the volatility in revenues and pre-tax income. Earnings of a securities firm are exposed to fluctuating market conditions. Securities firms' sources of income include brokerage from client trading in money and capital markets, income from proprietary portfolio, consulting and advisory fee, underwriting income and financing margin trades. Income from proprietary portfolio may include gains made on disposal of securities

as well as income from ready future arbitrage transactions. However, the quantum of investment in proprietary portfolio is assessed in comparison to net worth of the company and accordingly treated where a lower proportion to net worth is considered sound from rating perspective. Firms that manage to build a continuous source of revenues through more stable channels like fixed income investments are likely to be able to fare better during periods of low trading activities and are viewed positively from a ratings perspective.

VIS reviews the company's asset liability management procedures and any long term mismatches in its funding structures. The gearing and leverage levels of the company attained at various intervals during the year are important in assessment of ratings. Diversifying client base and developing a strong retail clientele is also vital to manage client turnover. Risks for smaller companies may be higher due to their inability to participate in the broader market or manage a large client base.

VIS reviews the risk management guidelines, which have been developed by the company and the extent of any deviation from these guidelines. These would also include the level of exposure taken on any client and the client assessment procedures being followed. Margin requirements from clients can mitigate the counter party exposure of the securities firm.

VIS also takes note of the internal policies defining the allowable aggregate amount of underwriting at any point as compared to the institutions own equity; this reflects the possible level of risk that may be undertaken by a firm. A higher net underwriting risk compared to net worth is considered to be risk prone. Exposure limits in terms of sector & business type supported by firewalls between underwriting and own trading as well as financial resources available to undertake multiple avenues of businesses will be important factors. Identification of skill and experience within the company to evaluate and handle underwriting transactions including evaluation models and financial indicators used, will be appraised.

Better rated securities firm are expected to have in place strong internal controls to mitigate operational risks. Mechanisms in place to eliminate chances of front running, errors in trading and investment, frauds and embezzlements will also be evaluated. Since at any given point, large numbers of transactions are being handled, losses from operational negligence could be substantial and may have long term consequences on the reputation of the company. Assessment also includes evaluation of any risk, which may be peculiar to the company.

Risk management should be a continuous process in the company. VIS evaluates the level of risk and the risk measurement & management tools being used and the extent of transparency. These tools should be robust enough to adapt to the changing needs of the company and the market. VIS places significant emphasis on the reliability of settlement and exposure management systems in place for handling trades on the stock exchange and with the clients. The management information system (MIS) should enable the company to carry out scenario and stress tests, identify concentration areas and signal non-compliance. Technology is one of the forces that have driven change in the capital markets. VIS reviews the pace of adoption of technology at securities firms and the degree of competitive advantage it may create, the prospect for new entrants resulting from technological change, such as online trading facilities, and the need for technological capital spending as a barrier to entry.

PERFORMANCE

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 stability of revenue from the core business of brokerage is considered important along with stable diversification in other businesses such as Corporate Advisory and Underwriting arrangement services. Support from proprietary investments and capital gains are treated as non-recurrent sources of revenue and accordingly assessed. Across time and industry comparison determine how well a securities firm 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.

SPONSORS STRENGTH, CAPITALIZATION AND LIQUIDITY

Sponsors franchise value and financial strength is important in assessment of the risk profile of the company. Brokerage houses owned or controlled by sound financial institutions and/or corporates may carry lower operational risk and credit risk in the market.

The stock exchange 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 firm. 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.

While credit, liquidity, concentration and market risks may be apparent from the company's financial statements, judgment is required as to 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 / un-utilized credit lines and cover repayment of liabilities.

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.





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 international 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 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 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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