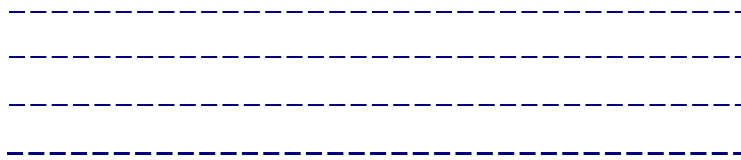




BROKER MANAGEMENT RATING

METHODOLOGY

An independent opinion on the quality of management and services provided by the broker



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FB-1, Awami Complex, Usman Block, New Garden
Town, Lahore

www.pacra.com



PAKISTAN CREDIT RATING AGENCY

BROKER MANAGEMENT RATING METHODOLOGY

1. INTRODUCTION

- Broker Management Rating
- SECP – the Regulator
- Key Regulations

1.1 Introduction - Broker Management Rating (BMR): Brokers play a critical role in the capital markets by facilitating trades for all categories of investors. Brokerage industry is characterized as very dynamic and volatile due to its direct dependency on the performance of capital markets. PACRA’s Broker Management Rating aims to facilitate investors to differentiate between brokers on the basis of quality of management and services provided.

1.2 Regulatory Landscape: Brokers are regulated primarily by the Securities and Exchange Commission of Pakistan. The regulator has designed a comprehensive set of laws and regulations for Brokers. Following are the key regulations applicable to the brokerage segment:

Securities Brokerage	Promulgated / Last Updated
Securities Brokers (Licensing and Operations) Regulations, 2016	Updated September 2017
Research Analyst Regulations, 2015	Updated August 2017
Securities and Future Advisors (Licensing and Operations) Regulations, 2017	April 2017
PSX Rule Book	Updated April 2017
CDC Regulations	Updated August 2016
Securities and Exchange Commission of Pakistan Act, 1997	Updated August 2016
NCCPL Regulations	Updated May 2016
Futures Market Act, 2016	April 2016
Anti-Money Laundering Act, 2010	Updated February 2016
Joint Inspection Regulations, 2015	October 2015
Securities Act, 2015	April 2015
Underwriters Rules, 2015	February 2015
Non-Banking Finance Companies (Establishment and Regulation) Rules	Updated October 2015
Securities and Exchange Ordinance, 1969	Updated 2012
Securities (Leveraged Markets and Pledging) Rules, 2011	February 2011
Commodity Exchange and Futures Contract Rules, 2005	March 2005
Central Depositories Act, 1997	April 1997

1.3 PACRA uses the key parameters listed in the table below to assess the quality of operations of a broker and the services offered by it. Each parameter is assessed individually. These assessments are then aggregated to arrive at the final rating.

Sr No.	Risk Parameter
1	Ownership and Governance
2	Management Quality
3	Customer Service
4	IT Infrastructure Adequacy
5	Risk Management
6	Regulatory Compliance
7	Financial & Business Sustainability

2. OWNERSHIP AND GOVERNANCE

- Ownership – Structure and Support
- Governance – Competence and Effectiveness

2.1 Ownership: Ownership structure and the objective of key shareholders are important to overall ownership assessment. PACRA analyzes the ability and willingness of the major shareholders to support the entity. Key factors that are considered for analysis purpose, inter-alia, include shareholding structure, financial strength of major shareholders, operational synergies with the owner’s other businesses, if any, and the level of commitment of the owner with the entity in providing capital support. Here, PACRA gives due importance to the behavior of sponsors to provide timely and comprehensive support in times of need in the past.

2.2 Governance: PACRA is of the view that the broker’s governance practices can have a material impact on the effectiveness of its operations. In governance assessment, PACRA analyses governance data and information systematically, and also performs more contextual, qualitative review of the company’s governance practices as per governance model of PACRA.

Sr. No.	Governance Structure
1	Board structure
2	Members’ profile
3	Board effectiveness
4	Financial transparency

3. MANAGEMENT QUALITY

- Management Team
- Organization Structure

3.1 Management Team: Good quality management implies that the broker has effective systems and controls, and well-defined strategy to achieve a desired level of excellence. PACRA assesses the management quality in terms of the experience profile of key individuals and their tenure with the company, dependence of the management team on one or more persons, coherence of the team and management’s past track record. PACRA also analyses the broker’s ability to attract and retain talent, and frequency and quality of the training imparted to the employees. Membership of local and foreign associations also provides comfort and contributes towards the enhancement of management quality.

3.2 Organization Structure: PACRA’s analysis of the organizational structure focuses on how the company is organized keeping in view the scope of operations, confidentiality and conflict of interest within departments as well as with the clients.

4. CUSTOMER SERVICE

- Client Servicing
- Complaints management

4.1 Client Servicing: The standard practices followed by the broker in servicing clients are evaluated. This helps assess the adequacy of these practices and the quality of services provided to the clients. Nature of value-added services provided (such as research/news updates and investor education programmes), dissemination of trading policies and procedures to clients, order recording and trade confirmation process, periodic reporting to clients and segregation of client money and assets from broker as well as from other clients are among the key parameters that PACRA evaluates.

4.2 Complaints Management: Nature and number of complaints received is an important indicator to measure the quality of services provided and resultant client satisfaction. PACRA also analyses the complaint management system in place and number of complaints received and pending against the brokerage company.

5. IT INFRASTRUCTURE ADEQUACY

- Extent of Automation / Integration
- Continuity of Operations

5.1 Extent of Automation / Integration: For the broker to be able to service clients effectively and efficiently, the systems’ backbone needs to be robust. The systems deployed need to be capable of capturing, processing and reporting all transactions of all clients with a zero or near-zero error rate. PACRA's evaluation of the infrastructure framework consists of an assessment of the infrastructure deployed, the extent of automation and integration, type and number of errors encountered, access policies to the computer systems and data, and the quality of reports generated by the MIS.

5.2 Continuity of Operations: PACRA also analyses the adequacy of infrastructure in place, adequacy of connectivity with the exchange, communication network, frequency of connection failure and time taken to restore the connection, database maintained, back up procedures, disaster recovery and business continuity plan, and documentation and monitoring of channels of communication etc. While broker’s existing IT systems may be adequate for current scale of business, PACRA also evaluates the broker’s focus on continuous improvement and ability to scale up its IT systems in line with the business growth.

6. RISK MANAGEMENT

- Operational Risk and Control Environment
- Credit Risk
- Market Risk
- Liquidity Risk

6.1 PACRA assesses the robustness and reliability of the risk management systems. Evaluating the overall risk management framework enables to determine how various risks are identified, monitored and mitigated across the brokerage house. The efficiency of controls and effectiveness of the internal audit function within a brokerage house is instrumental in mitigating risks arising from operational failures.

6.2 Operational Risk and Control Environment: Operational risk is the risk of loss resulting from inadequate or failed internal processes, unauthorized trading, misappropriation of the clients’ money, breach of clients’ confidentiality, fraud in trading or in back office functions and easily accessed computer systems. An analysis of the company’s following policies and procedures and update frequency helps to determine the viability of the operational control environment against unanticipated errors and failures.

Policies & Procedures
1. Conflict of interest
2. Confidentiality specially existence of ‘Chinese Wall’ and intra-client confidentiality barriers throughout the company
3. Insider trading and market abuse
4. Internal code of practice
5. Trading by employees
6. Trade review procedure
7. Book keeping and record retention

6.3 Credit Risk: Credit 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, liquidation of client accounts where necessary and number of days receivables are outstanding.

6.4 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. PACRA examines the general strategy with regards to proprietary trading, stability and profitability of sectors and companies invested in, cut-offs for exit from stock market and measurement of risk (Value at Risk – VAR, stress scenarios etc).

6.5 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 brokerage’s ability to raise timely and cost-effective funds from external sources.

7. REGULATORY COMPLIANCE

7.1 Regulatory compliance is very important in the broking industry due to the stringent implementation of rules by the regulators and the possibility of suspension of operations if rules are breached. PACRA assesses the internal control measures adopted to ensure adequate legal and regulatory compliance. An objective assessment of the attitude of management towards legal compliance and the systems set in place to ensure compliance provide assurance that the broker's service continuity will not be affected by the regulator's penal action. Compliance levels are examined in detail, especially with regards to the internal audit, system audit and CDC audit. Correspondence with the SECP, PSX, CDC and NCCPL is evaluated along with any regulatory matters outstanding or actions taken by the regulators. Any litigation pending against the broker is also considered.

8. FINANCIAL & BUSINESS SUSTAINABILITY

- Business Risk
- Financial Risk

8.1 Business Risk: Business risk is the possibility that a broker will have lower than anticipated profits or experience a loss. It impairs a broker’s ability to provide its investors and stakeholders with adequate returns. The broker’s business strengths and financial soundness are assessed to ascertain the sustainability of its operations.

8.1.1 Business Profile: PACRA assesses the company’s branch network, number of licenses the company holds for carrying out different activities, category under which the company has obtained license (Trading and Self Clearing, Trading and Clearing or Trading), whether it is listed or unlisted, number of clients’ CDS account i.e. investor accounts and sub-accounts and market share.

8.1.2 Revenue and Profitability Analysis: PACRA also analyses the revenue quality. PACRA sees concentration at both product and customer levels. Broking businesses derive strength from diversity of revenue streams; brokers that are not dependent on a few major players, and therefore, have low concentration risk, are better placed. 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 relateness in the industry, and operational profitability. The alternative revenue streams from underwriting and advisory are analyzed to form a view on how significant these are and whether these represent a sustainable revenue stream.



8.2 Financial Risk: Given the volatile nature of the equity broking industry, the broker’s ability to maintain the related capital regime is analyzed to form a view as to the sustainability of operations. Strong capital levels provide necessary cushion in terms of absorbing any delay in collections from clients and losses during bad capital market.

Business Risk and Financial Risk – Important Ratios
Net income / total revenue
Operational expenses / total income
NCB / Equity
Total debt / Equity

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BROKER MANAGEMENT RATING SCALE

SYMBOL	DEFINITION	
BMR 1A	Excellent	Excellent regulatory compliance, control environment, and financial management; governance and risk management frameworks are extremely effective; HR, IT, and customer services are strongly proactive.
BMR 1++ BMR 1+ BMR 1	Strong	Strong regulatory compliance, control environment, and financial management; governance and risk management frameworks are highly effective; HR, IT, and customer services are highly proactive.
BMR 2++ BMR 2+ BMR 2	Sound	Sound regulatory compliance, control environment, and financial management; governance and risk management frameworks are effective; HR, IT, and customer services are proactive.
BMR 3++ BMR 3+ BMR 3	Adequate	Adequate regulatory compliance, control environment, and financial management; governance and risk management frameworks are satisfactory; HR, IT, and customer services are adequate.
BMR 4++ BMR 4+ BMR 4	Inadequate	Inadequate regulatory compliance, control environment, and financial management; governance and risk management frameworks need improvements; HR, IT, and customer services are insufficient.
BMR 5	Weak	Weak regulatory compliance and business practices.

SURVEILLANCE AND VALIDITY OF THE RATING

PACRA shall not keep the Broker Management Rating under constant surveillance. The rating will be reviewed at least once every six months. Any material happening during a period that may warrant a revision of rating will be incorporated in the following review.

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’.

WITHDRAWN

A rating is withdrawn on a) termination of rating mandate, or b) cessation of underlying entity.

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