August, 2017

JCR-VIS
RATING
METHODOLOGY

Corporate Governance Ratings

The term 'corporate governance' covers a broad spectrum of activities of the Board of Directors (BoD) and the management of an organization. The Organisation 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 fatal 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 preparing policy and strategy and monitoring the 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 the running of the organization on an ongoing basis. Since the basic qualification for membership of the BoD is shareholding rather than professional expertise, the BoD can become dependent on the management for guidance relating to the more technical aspects of the business.

The realization of this problem crystallized in the early 1990's in the United Kingdom following a string of high profile corporate failures including 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.

The 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 director's be determined by a sub-committee of the BoD comprising primarily of outside directors and 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, preventing effective corporate governance. However, 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. 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 BoD structure and 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 committee's 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 and certain recommendations have been subsequently 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 of its own and this has caused an increase in efforts world wide 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 the interests of the shareholders and other financial stakeholders.

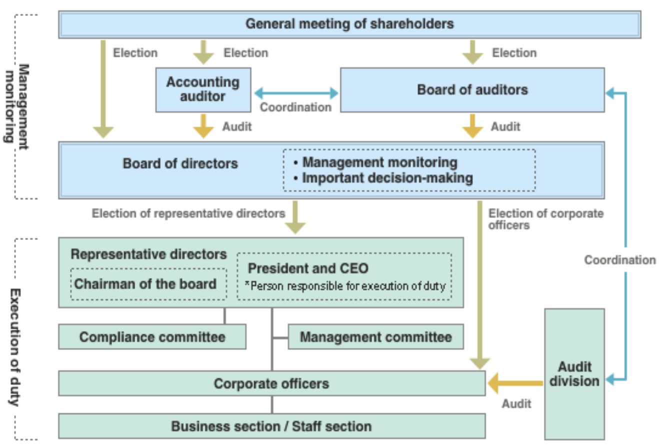
The Pakistan Context

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 including Mehran Bank, Bankers Equity, Indus Bank and Prudential Bank occurred due to factors that would have been avoidable had strong corporate governance procedures been 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 preparing policies and supervising the performance of management.

The SECP has also issued a Code of Corporate Governance, which has been made part of the listing requirements of the Pakistan Stock Exchange (PSX) . This code is a combination of several mandatory and voluntary provisions, which cover almost the entire spectrum of issues that need to be addressed to create a proper environment for corporate governance. The preparation of such a code in a developing economy like Pakistan's is indeed a commendable effort and, if properly implemented, will go a long way in restoring investor confidence in the economy.

Corporate Governance Ratings (CGRs)

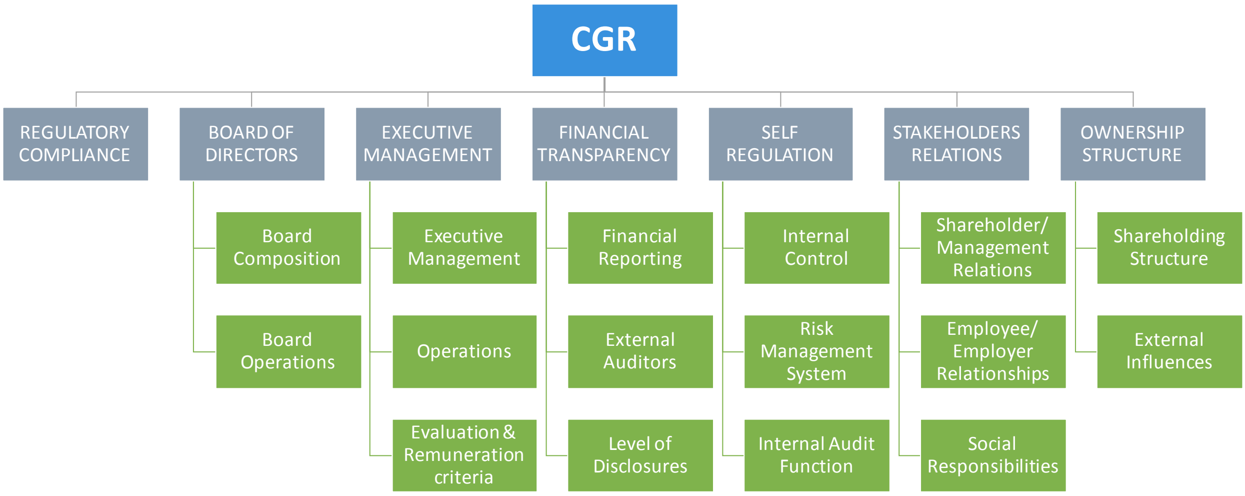
At its broadest, corporate governance comprises the framework of rules, relationships, systems and processes within and by which fiduciary authority is exercised and controlled in corporations. The typical framework is outlined in the graphic below:



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 are also in close touch with the regulatory framework existing in the environment in which they operate and have a good understanding of the various kinds of risk 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.

JCR-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 best 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, JCR-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 JCR-VIS examines while assigning a CGR:



RATING SCALE & DEFINITIONS: CORPORATE GOVERNANCE

CGR 10
Highest level of corporate governance

CGR 9++, CGR 9+, CGR 9
Very high level of corporate governance

CGR 8++, CGR 8+, CGR 8
High level of corporate governance

CGR 7++, CGR 7+, CGR 7
Moderately high level corporate governance

CGR 6++, CGR 6+, CGR 6
Satisfactory level of corporate governance

CGR 5++, CGR 5+, CGR 5
Adequate level of corporate governance

CGR 4++, CGR 4+, CGR 4
Moderately low level of corporate governance

CGR 3++, CGR 3+, CGR 3
Low level of corporate governance

CGR 2++, CGR 2+, CGR 2
Very low level of corporate governance

CGR 1++, CGR 1+, CGR 1
Lowest level of corporate governance

Governance Watch: 'Governance Watch' may be assigned to highlight identifiable governance events that necessitate re-evaluation of the assigned rating. A 'Governance Watch' announcement means that the status of the assigned rating is uncertain and an event or deviation from an expected trend has occurred or is expected and additional information is necessary to take a rating action.

Faheem Ahmad

President & CEO, JCR-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.

Maimoon Rasheed

Director Methodology & Criteria Development

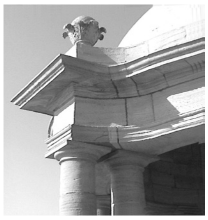
Maimoon possesses 12+ years experience in financial risk assessment with focus on credit ratings, conventional finance, and general management. He possesses management experience in the fields of financial risk modeling, asset management and brokerage. He has been actively involved in both buy and sell side capital market research.

Maimoon's overall experience comprises ratings of entities across a range of sectors including financial – commercial banks, investment banks, asset management companies, leasing companies, modarabas, securities houses and insurance companies – and corporates in different industries. He obtained his B.S in Applied Geology from Punjab University, Lahore. He also has Masters Degrees in Business Administration with majors in Finance.

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.



Jahangir Kothari Parade

National Excellence, International Reach

JCR-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, JCR-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, JCR-VIS continues its endeavor to remain an emblem of trust.

JCR-VIS Credit Rating Company Limited

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