



CORPORATE GOVERNANCE RATINGS

Rating Methodology

The term 'corporate governance' covers a broad spectrum of activities of the Board of Directors (BoD) and the management of an organisation. 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.'

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organisation in the belief that all the decisions made by them would be in the interest of the organisation 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 organisation 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 organisation 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 realisation 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,

Colo rol Group and Pol lypeck In ter na tional PLC among oth ers. The gen eral feel ing was that these fail ures were gen er ally caused by weak cor po rate in ter nal sys tems, in ade quate BoD su per vi sion over man age ment and ex ces sive cen tral iza tion of pol icy mak ing pow ers in the hands of a small num ber of ex ecu tives. In re sponse to this out cry the Gov ern ment of the United King dom in 1991 ap pointed the Cad bury Com mit tee, which was headed by lead ing Brit ish in dus tri al ist Sir Adrian Cad bury, to '... ad dress the fi nan cial as pects of cor po rate gov ern ance.' This was prob a bly the first time that a for mal link age was made be tween cor po rate gov ern ance and the fi nan cial per form ance of a com pany.

The two key rec om men da tions of the Cad bury Com mit tee, laid out in 'The Code of Best Prac tise', were that every BoD should in clude three in de pen dent, non ex ecutive di rec tors and that the of fices of Chief Ex ecutive and Chair man of BoD should not be held by the same per son si mul ta ne ously. Other rec om men da tions of the Cad bury Com mit tee in cluded dis clo sure of the re mu nera tion of the chair man and the high est paid di rec tor, ap pro val by share hold ers of con tracts of ex ecu tive di rec tors which were in ex cess of three years in length, pay of ex ecu tive di rec tor's be de ter mined by a sub com mit tee of the BoD com pris ing pri mar ily of out side di rec tors and an other sub com mit tee of sim i lar com po sition be con sti tuted to re port on the in ter nal con trol and risk man age ment sys tems of the com pany. The rea son ing be hind

these rec om men da tions is ob vi ous. In any or ga ni sa tion in which these rec om men da tions were not being im ple mented, the de fin ing line be tween su per vi sors (i.e. the BoD) and the su per vised (i.e. the man age ment) be comes blurred, pre vent ing ef fec tive cor po rate gov ern ance. How ever, it is im por tant to note that the 'The Code of Best Prac tise' has not been made part of UK cor po rate law and hence com pli ance is only vol un tary. Some strength is de rived from the fact that the Lon don Stock Ex change re quires all listed com pa nies to state whether they are in com pli ance with the code and if not, pro vide ex pla na tions for the de via tions. This quasi regu la tory pres sure to en force the code has borne fruit with a vast ma jor ity of listed com pa nies fall ing in line with the pro vi sions of the code.

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In 1998 the Chair man of the Se cu ri ties & Ex change Com mis sion of the USA, A. Le vitt, stated:

'Qual ified, com mit ted in de pend ent and tough minded audit com mit tees rep re sent the most re li able guard ians of the pub lic in ter est'.

With Le vitt's en cour age ment, the NASDAQ and NYSE formed the Blue Rib bon Com mit tee (BRC). The man date 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 watch dogs. 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 groundbreaking efforts, the understanding of the importance of corporate governance has taken an impetus of its own and this has caused an increase in efforts worldwide to tighten external monitoring of corporate governance. But, as with all new corporate concepts, corporate governance is an evolving field. The recent Enron disaster has once again 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 in Pakistan 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 during the last decade (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 realisation 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.

Corporate governance acquires further significance in the Pakistani context in view of the fact that the process of privatization of state assets, which had remained slow up to now, is ready to take-off. On the privatization list are assets of strategic and/or economic importance, the future performance of which will have a critical impact on our growth. Ensuring good corporate governance is probably the best way to ensure that these institutions play their due role subsequent to their privatization.

The SECP has also recently announced a Code of Corporate Governance, which has been made part of the listing require-

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ments of all three stock exchanges in the country. 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

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

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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

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confidence in corporate governance practices can be enhanced through the use of a third-party opinion. Finally, in Pakistan, there are several institutions (both state and privately owned) where a corporate culture has only emerged in the past few years. Since these institutions are still carrying the heavy baggage of their past, the efforts of their respective managements can not exactly be translated into strong financial performance. However, these managements should receive the credit for the hard work they have put in to restructure and turn around these institutions by improving systems and policies. The extent of good governance practices implemented by these managements can be assessed through CGRs.

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:

■ **Ownership and Board**

Structure - The main issues here are the clarity of the ownership structure of the institution being rated and the composition of the BoD. This would include, among other things, an examination of how minority interests are protected and whether there are a sufficient number of independent directors on the BoD who are able to understand the business and make a positive contribution to the policy-making and supervision activities of the BoD. The management systems of the company are also covered under this head.

■ **Transparency and Disclosures**

- This basically covers the quality of financial reporting by the institution, i.e. the level of detail in the disclosures, the frequency of reporting and the quality of the auditors. It must be noted here that meeting minimum statutory disclosure requirements will not necessarily qualify a company for a high score in this area.

■ **Stakeholder relations**

- To assess this area, JCR-VIS basically carries out a review of the company's dividend payout history, variations of rights between different classes of shareholders and mechanisms to redress stakeholder grievances.

JCR-VIS uses a scale of CGR-1 to 10 to rate corporate governance in an individual institution with CGR-10 being the highest possible rating (please refer to scale).

Corporate Governance Rating Scale & Definitions

CGR-10

Highest level of corporate governance.

CGR-9

Very high level of corporate governance.

CGR-8

High level of corporate governance.

CGR-7

Moderately high level of corporate governance.

CGR-6

Satisfactory level of corporate governance.

CGR-5

Adequate level of corporate governance.

CGR-4

Moderately low level of corporate governance.

CGR-3

Low level of corporate governance.

CGR-2

Very low level of corporate governance.

CGR-1

Lowest level of corporate governance.

Suspension

In the event that JCR-VIS deems that, as a result of lack of cooperation with regard to the provision of information or for any other reason, it is not possible to assess the current status of the assigned rating, the rating will be suspended.

Withdrawal

A rating is withdrawn in the following situations:

- a) Non-renewal/cancellation of the rating agreement; and
- b) Cessation of an entity for any reason.



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Faheem Ahmad has diverse experience with international consulting agencies in USA & Middle East. He has also held senior positions with local industrial and financial groups. In 1994, he established Vital Information Services (Pvt.) Limited, which is a leading capital market research house. VIS has the largest data bank of corporate Pakistan. His major research work includes copyrighted F&J financial strength rankings, Musharaka Variable Income Securities and stock market indices. VIS group includes JCR-VIS Credit Rating Company Limited and News-VIS Credit Information Services (Pvt.) Limited, the first private credit bureau of Pakistan. The majority of shareholders in group companies include the largest publication house in Pakistan and major financial institutions. 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. His research work has been published in various international journals.



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Safdar Kazi is a Senior Vice President and a member of the rating committee in JCR-VIS. He has over 30 years of senior level experience in commercial banking, leasing, investment banking, IT and the manufacturing industry. Prior to joining JCR-VIS, he was the EVP in a leading investment bank where he had worked as the Head of Corporate Finance and Operations. He also has senior level experience in the leasing & commercial banking sector. He received his MBA from the University of Wisconsin, Madison with double majors in Accounting and Information Systems Analysis and Design.



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Saad Ahmed Madani currently leads investment banking & DFIs ratings. He has worked extensively on industry and Islamic Finance ratings and is also involved in ratings of various leasing companies and commercial banks. He is a Chartered Accountant (CA) from the Institute of Chartered Accountants of Pakistan.

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