



Securities and Exchange Commission of Pakistan
Securities Market Division

Through Courier

Before the Commissioner (SMD)

In the matter of Show Cause Notice issued to JCR-VIS Credit Rating Company Limited

Date of Hearing	August 07, 2019
Present at the Hearing	a. Ms. Faryal Faheem (Deputy CEO)
Representing JCR-VIS Credit Rating Company Limited	b. Mr. Ali Raza (Compliance Officer)

ORDER

This Order shall dispose of the proceedings initiated against JCR-VIS Credit Rating Company Limited (the “**Respondent**”) through Show Cause Notice No. 1(5) SMD/ADJ/JCR/2019, dated July 17, 2019 (the “**SCN**”) under Section 159 of the Securities Act, 2015 (the “**Act**”).

2. Brief facts of the case are that the Respondent is licensed as a credit rating agency with the Securities and Exchange Commission of Pakistan (the “**Commission**”).

3. The Commission in terms of Section 138 of the Act conducted an inspection of the Respondent vide its order dated May 15, 2018 to ensure compliance status of regulatory requirements contained in Credit Rating Companies Regulations, 2016 (the “**Regulations**”). The Report was submitted on December 10, 2018 (the “**Report**”) after receiving comments of the Respondent on letter of findings (“**LOF**”) dated October 19, 2018.

4. The Report revealed that the Respondent was found non-compliant with the Regulations detailed as under:

- i. It was observed that two members of the rating committee are analysts themselves and acting as member in rating committee having voting rights, which reveals biasness and conflict of interest in the rating process. (Violation of Regulation 11(A)(h) of the Regulations)
- ii. Respondent did not conduct internal audit review and not presented internal audit report to the board. It is also observed that the Respondent did not develop the separate internal audit department to conduct periodic audit review of compliance of Regulations. (Violation of Regulation 11(B)(l) of the Regulations)
- iii. Respondent had not updated HR Manual/Policy in line with the requirement of the Regulations. (Violation of Regulation 11(B)(b) of the Regulations)





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- iv. Respondent had not developed and approved risk policy, procedure and TORs for its risk management committee to enable it to identify, assess, mitigate, control and monitor risks arising from its activities. The Respondent has not provided the minutes of the meeting of the risk management committee which depicts that no risk management system is in place. (Violation of Regulation 11(B)(d) of the Regulations)
- v. Respondent had not:
- a. updated the manuals for Banks, Asset Management Quality and Fund Stability.
 - b. developed the manual for the industries namely securities brokers, leasing, corporate governance, life insurance and instrument rating.
 - c. updated bank loan rating methodology since 2011.
 - d. been found consistent in models, methodologies and manuals e.g. Star Ranking (First Habib Stock Fund), preference share rating, broker management rating, asset manager quality.
- (Violation of Regulation (C)(b) & (C) of the Regulations)
- vi. Respondent was not in practice of discussion with auditors and creditors of the Company. (Violation of Regulation 11(C)(o) of the Regulations)
- vii. Respondent had not submitted initial indicative rating to rating committee. (Violation of Regulation 11(C)(t) of the Regulations)
- viii. Respondent had not provided supporting documents for compliance with ACCRA Code of Conduct. The Respondent Code of Conduct has not been updated in line with the applicable regulatory framework. Further, the Respondent has not provided the documentary evidence with regard to the implementation of the IOSCO principles. (Violation of Regulation 11(D)(a) & (b) of the Regulations)
- ix. Compliance officer of the Respondent was also involved in the rating operations. (Violation of Regulation 11(F)(c) of the Regulations)
- x. Respondent had deviated from its fee structure and have charged less than the amount mentioned on the website therefore, is in violation of the said regulations. (Violation of Regulation 15 of the Regulations)
- xi. Respondent had not conducted the mid-year review of its outstanding rating. (Violation of Regulation 17(b) of the Regulations)
- xii. Respondent had not conducted the sector specific studies on NPO and NBFC like leasing and modarbah sector, auto mobile industry. Further the Respondent has not updated industry specific studies on Confectionery and LPG industry since 2011. (Violation of Regulation 19(3) of the Regulations)
- xiii. It is observed that in case of Sukuk issued by Hascol Petroleum, the tenure of the instrument, detail of collateral and name of the trustee were not mentioned in the report. It was also observed





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that collateral or security underlying the Sukuks were not specifically identified. (Violation of Regulation 14(3)(g) read with Annexure H of the Regulations)

5. In view of the aforesaid, the Respondent *prima facie* acted in contravention of the Regulations. The Commission, therefore, took cognizance of the aforesaid violations, issued SCN dated July 17, 2019 to the Respondent. The Respondent vide its letter dated August 06, 2019 submitted reply to the SCN wherein reference has also been made to their previous letter provided in response to the LOF shared with the Respondent. Point wise reply of the Respondent is reproduced as under:

a. Point 3(a) -

We duly acknowledge that such an arrangement does create conflict of interest. This had occurred a few times in 2017 when we were in the process of appointing external RC members and getting their approval from SECP. To facilitate few rating announcements at that time these abnormal arrangements were resorted to. Since the beginning of CY2018, it is ensured as a policy and practice that no such occurrence takes place anymore.

b. Point 3(b)

We were in discussion with SECP on the interpretation of this Regulation and expressed our reservation that it would not be possible for us to create an internal audit department or assign a full-fledged internal auditor. The request is recently accepted and JCRVIS designated Mr. Saeed Khan, Director Finance to fulfill the requirements of this Regulation. It is planned that the required review and assessment will be completed within FY 2019 and a comprehensive report will be submitted to the BOD.

However, Compliance Reports developed by the CO on quarterly basis are now first submitted to Mr. Saeed Khan who forwards them to the BOD after review and assessment of compliance level.

c. Point 3(c)

Human resource policy document was under development in line with the requirements of Regulation 11.B.b. The same is now completed and once approved internally, will be presented to the HR Committee for review and approval. However, it is important to mention here that JCR-VIS does have an HR Policy documented and implemented which was developed in line with the previous Regulations. Subsequently, the revised HR policy was approved by the HR Committee and submitted to the BOD. BOD approval is awaited.

d. Point 3(d)

It is internally under discussion as there is no regulatory requirement to create a RMC, the responsibilities mentioned in Regulation 11.B.D may remain with the higher management. All policies and procedures developed and implemented in JCRVIS are created keeping in view different nature of risks associated with its operation aversion of which is ensured by the higher management since beginning.

e. Point 3(e)

A: Operational Manuals for any rating product are not required to be updated unless there occurs a change in our procedures. However, all Manuals are reviewed periodically by the Criteria Group. However, it is internally decided that the date of latest review will be updated on each Manual.





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The missing Manuals pointed out by the inspection team are in the process of development and will be completed in due course of time.

***B:** All older versions are being updated and will be publicly disseminated soon. Methodologies for BLR and Star Rankings are already updated.*

***C. 1. 1 through 3:** Highlighted issues are addressed in the updated versions of methodology and rating reports;*

***C. 1. 4:** Please note that JCRVIS has devised its own method for estimation of risk associated with a fund. We believe that ours is an indigenously developed criteria and does not require conformity with any existing method as long as it is able to discriminate between quality of funds across the board and the methodology is transparent.*

***C. 1. 5:** The matter has been resolved.*

***C.2.1:** Preference Shares Rating:*

JCR-VIS previously had separate methodology for rating preference shares; however, the methodology was incorporated in a new methodology 'Notching the Issue' released in June 2016. The new methodology, which could be accessed at http://jcrvis.com.pk/docs/criteria_instrument_16.pdf covers JCR-VIS 's views on preference shares.

C.2.2: PGPC

1. Initially, projected cost of the project amounted to Rs. 14.3b with a proposed debt-to-equity ratio of 60:40. On completion of project, the total cost increased to Rs. 15.6b. Actual cost of the project has exceeded the projected cost mainly on account of increase in FSRU import duties, exchange rate fluctuation and increase in cash margin requirement for performance bonds and guarantees. At end-1H FY18, the total project was being financed by equity amounting Rs. 4.58b (with ordinary and preference shares amounting at Rs. 3.14b & Rs. 1.53b, respectively), trade & other payables of Rs. 9.21b, long-term debt of Rs. 1.27b and other liabilities amounting 0.5b. With the increase in project cost, revised loan portion was projected at Rs. 9.355b to be mobilized from banks and DFIs (previously the loan amount of Rs. 8.6b was projected which was to be mobilized primarily through Sukuk issue – change in funding plan). With debt to equity ratio of 60:40, loan portion from Syndicate banks and DFIs (previously mainly through Sukuk issue) will primarily be utilized to retire liabilities payable to EPC contractor and other project related liabilities (till end-1H FY18, cash flows mainly emanated from equity injection while cash flows mainly to pay EPC contractor and other project related liabilities are planned to be mobilized primarily through bank borrowings).

2. Meanwhile, a certain portion of the project increase will be met through issue of preference shares capital and also through profits generated by the company, to maintain proposed debt-to-equity ratio as stated in the rating report.

3. As only type of borrowings changed from Sukuk to bank loans while maintaining the gearing at the required level, therefore, non-issuance of Sukuk did not affect Entity or Preference Shares ratings.

C.3: BMR

We gratefully acknowledge the observations raised by the inspection team. The same have been forwarded to our Criteria Group for their review. The Group being the final authority





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to approve any methodology update, it would be its decision to incorporate the observations or otherwise.

C.4. AMO:

1. We have investigated the same, updated the model to incorporate negative returns and have been using the new model for the last two quarters. Thus the observation is remedied by JCR-VIS already.

2. Noted; the required action will be taken in due course of time.

f. Point 3(f)

i. JCRVIS as a practice summarize and record the discussions held in all RC meetings. The final report of an RC meeting is very comprehensive and all encompassing view points of all participants, including the dissenting ones too. However, we are planning to change the format in minutes form; for which a senior editorial resource has also been appointed.

ii. Discussions with auditors and creditors are out of the scope of our rating exercise and are not practiced internationally too. CRAs rely on the audited financial reports which also contain an auditor's report and details of creditors; however the management is probed in depth in case a qualification is highlighted by the auditors.

Moreover, SECP will also be approached for the removal of this requirement from the Regulations.

Subsequently, format of Rating Committee Meetings Minutes is improved to enhance clarity.

g. Point 3(g)

Please note that like Star Rankings of funds, BMRs are also derived digitally on the basis of data/information fed into a computer system; therefore, it is not possible and advisable for an analyst to come up with an indicative rating in case of BMR.

The case of Shataj Textile was discussed with Ms. Muniba Khan who submits that she had given an indicative rating of BBB+ which was finally raised to A- by the RC. However, the same was not properly documented. We ensure to avoid any such instance in future.

h. Point 3(h)

The existing COC of JCRVIS has to be updated in line with the applicable Regulations; process to do so has already been initiated. It is planned that the new COC will simultaneously address the requirements of local Regulations and those of ACRAA and IOSCO as well.

It is reiterated that VIS is not in breach of a clause of IOSCO or ACCRA Codes.

i. Point 3(i)

The Regulations restrict CO to participate in the 'rating operation' of the CRA. The exercise to conduct Star Rankings is totally digital with no human opinion involved. The F&P criteria restricts heading two senior positions ONLY in case there exist an opportunity for conflict of interest. We believe that the process, being totally digital in nature with no human opinion, is devoid of any sort of conflict of interest for CO.

It is resubmitted that the CO is not involved in the rating process.

j. Point 3(j)

In all observed cases, a concessionary fee was negotiated by the client due to the fact that JCRVIS was conducting more than one rating of the same client.



Moreover, SECP has advised both CRAs to coordinate with each other and revise their fee schedules on rational basis as the existing schedules were developed long time ago and the current market dynamics does not allow the documented levels in practice.

Both CRAs are still in consultation for finalization of new fee slabs. Additionally, the methodology of calculating a "cumulative fee" (as adopted by the SECP inspection team in the LOF) as no as practiced locally or internationally.

k. Point 3(k)

All corporate clients under surveillance are contacted on quarterly basis and a set of information is sought. Rating announcements are made only in cases where a rating revision is anticipated based on the information received.

A similar format is also being developed for financial sector clients and similar practice will also be initiated with them soon.

l. Point 3(l)

The regulation requires conducting sector studies on annual basis, but is silent on number of such studies and about selection of sectors;

JCRVIS as a policy select sectors by choice considering the number of its existing clients in a sector or in case there is a new development in any sector. Moreover, JCRVIS also lays higher emphasis on the quality of analysis and reports rather than the number of studies published in a year.

m. Point 3(m):

Our submissions are as follows:

- Tenor of the instrument: Mentioned in issue details on website
- Name of trustee: Mentioned in issue, details on website.
- Details of Collateral: The public report mentions the security structure of the Sukuk. It should also be mentioned here that unlike for banks, physical security is not considered as a strong rating driver. Cash entrapment mechanisms are described in detail wherever available and have a bearing on ratings of instruments.

Redemption schedule along with specific payment dates is also available in the issue details. It is important to note that all relevant details are available in the public domain.

The following statement has been provided in the Public Report:

Sukuk of Rs. 2.0b carries profit rate of 3months KIBOR plus 1.5% per annum that is payable quarterly. Security structure of the Sukuk entails formation of a debt payment mechanism to progressively retain upcoming installment in an escrow account. Security structure also includes first pari passu charge over specific depots and retail outlets of the company inclusive of a margin of 25%.

The above is in addition to other details included in the detailed report including tenor, trustee etc.

6. The Respondent was accorded hearing opportunity on August 07, 2019. Ms. Faryal Faheem (Deputy CEO) and Mr. Ali Raza (Compliance Officer) attended the hearing as Authorized Representatives on behalf of the Respondent. During the hearing proceedings, the Authorized Representatives besides submitting additional arguments, reiterated the argument as submitted in response to the LOF and SCN.





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7. I have examined the submissions of the Respondent and its Representatives. In this regard, I observe that

- a. With regard to the biasness and conflict in the rating process and the instances observed therewith, the Respondent admitted to the observations of the inspection team and provided that few such instances occurred in 2017 when it was in the process of appointing external RC members. The viewpoint of the Respondent is not tenable as the observation has been highlighted due to internal conflict of interest due to the involvement of rating analysts in rating committee. Holding both positions simultaneously creates an inherent conflict of interest and self-advocacy risk, thereby, leading to question of transparency of the rating process. The Respondent during the hearing also admitted to the same and provided that it had taken reasonable steps to remove biasness/ conflict in the rating process and shall ensure that no such occurrence takes place in future. The Respondent was therefore, found non-compliant with Regulation 11(A)(h) of the Regulations. The Respondent is advised to follow the essence of the Regulations in letter and spirit and avoid any such instances in future.
- b. With regard to the deficiencies highlighted in the Internal Audit Review of the Respondent, the Respondent during the hearing admitted that they had not created an internal audit department or assigned a full-fledged internal auditor due to internal limitations. Further, the Respondent provided that their Director (Finance) was designated as Head Internal Audit to fulfil the requirement of this regulation. The Respondent also submitted that they were in discussions with the Commission on the interpretation of this Regulation and expressed its reservations that it would not be possible for them to create an internal audit department due to financial/ resource limitations. However, the Respondent failed to produce any documentary evidence regarding discussions made with the Commission for relaxation of the said requirement. Further it is highlighted that the Regulations are binding in nature and no relaxation in the requirement of the said regulation has been made till date. Also, the dual role of Director (Finance) as an Internal Auditor poses an inherent conflict of interest. The Respondent is therefore, found non-compliant with Regulation 11(B)(I) of the Regulations.
- c. With regard to the upgradation of its HR Manual as per the requirements of the Regulations, the Respondent during the hearing iterated that their HR policy was in line with the previous regulations. The Respondent during the hearing submitted a copy of its HR policy namely "Human Resource and Employee Service Rules" updated in March, 2019. BOD approval on its updated HR Manual is still awaited. The HR policy was not updated during the time of inspection and not approved by its BOD till date therefore, the Respondent is found non-compliant with Regulation 11(B)(b) of the Regulations.
- d. With regard to the development of comprehensive risk management system and controls, the Respondent submitted that there is no requirement to create a risk management committee ("RMC"), and the responsibilities mentioned in the said regulations may remain with the higher management. The stance of the Respondent is acceptable to the extent that the Regulations do not prescribe the formation of RMC however, the Respondent failed to produce evidence of any policy or procedures to identify, assess, mitigate, control and





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monitor risks arising from its activities as required under the Regulations. Therefore, the Respondent was found non-compliant with Regulation 11(B)(d) of the Regulations.

- e. With regard to the development of rating manuals, upgradation of criteria, methodologies and procedures as per the market conditions, inconsistencies in models, methodologies and manuals for rating assignments and the observation highlighted therewith, the Respondent during the hearing submitted:

- Some of the manuals have not been updated as there has been no change in the same.
- Broker Management Rating (“BMR”) & Star Ranking of Funds are derived digitally on the basis of data/information fed into the system therefore, manuals for the same have not been updated.
- It had developed a separate methodology for preference share rating released in June, 2016.
- It had developed its own method for estimation of risk associated with funds (Star Rankings) which is an indigenously developed criteria and does not require conformity with any existing method as long as it is able to discriminate between quality of funds.

The contention of the Respondent with regard to the violation of Regulation 11(C)(b) & (c) of the Regulations can be regarded as justifiable. The Respondent further advised to:

- Ensure that manuals are proactively updated considering changes in the market environment.
- Develop rating manuals for all industries for which the rating assignments are carried out by the Respondent.
- Follow best international practices in line with the requirements of the Regulations.

- f. With regard to record keeping of discussions with issuer, its management, auditors & creditors which have a bearing on the credit rating, the Respondent during the hearing informed that they do not have a practice of assessment whether such a discussion with auditors/ creditors during a credit rating review is necessary. They rely on information provided in the audited financial reports and details of creditors. Further, the Respondent also informed that they will approach the Commission for removal of this requirement from the Regulations. As stated earlier, the Regulations are binding in nature and no amendments in the said requirement of the Regulations have been made till date. The reply of the Respondent indicates that the procedure does not include case wise assessment whether discussion is required with the auditors or the creditors which is against the spirit of the regulatory framework. Therefore, the Respondent is found non-compliant with Regulation 11(C)(o) of the Regulations. Further, the Respondent is also advised to assess whether credit rating of a company requires consultation/ discussion with auditors & creditors for effective rating of a company as required under the Regulations and the same be documented.

- g. With regard to the submission of initial indicative rating to the Rating Committee, the Respondent during the hearing provided that initial indicative rating in case of BMR is not possible as it is derived digitally on the basis of data/information fed into the system. In case of BMR, the viewpoint of the Respondent is not tenable as there are certain quantitative and qualitative factors involved in BMR. Therefore, the analyst should provide an indicative





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rating which should be forwarded to the RC for further deliberations. With regard to the credit rating of the company, the Respondent admitted to the observation highlighted and provided that the indicative rating was not properly documented. The Respondent is therefore, found non-compliant with Regulation 11(C)(t) of the Regulations.

- h. With regard to compliance with Regulation 11(D)(a) & (b) of the Regulations to follow best practices guidelines for regional and international association of credit rating agencies and adaptation of requirements of the Code of Conduct for credit rating companies issued by International Organization of Securities Commission, the Respondent in response to the SCN provided that it is not in breach of any clause of IOSCO or ACCRA Code of Conduct. Further, the Respondent also submitted copies of compliance reports with IOSCO Code of Conduct and ACRAA's Fundamentals for Domestic Credit Rating Companies. The viewpoint of the Respondent in this regard is tenable. The Respondent is further advised to follow best international practices in letter and spirit unless provided otherwise in the Regulations.
- i. With regard to the participation of compliance officer in rating operations in contravention of the Regulations, the Respondent during the hearing submitted that the instances were observed in the star ranking which is a digital process with no human opinion involved. Further, the Respondent also provided that the said non-compliance has been removed. The Respondent's view point in this regard is not tenable as the Regulations clearly contravenes the participation of compliance officer in rating operations. The Respondent was therefore, found non-compliant with Regulation 11(F)(c) of the Regulations.
- j. With regard to the deviation from its fee structure for rating services, the Respondent submitted that in the instance cases, concessionary fee was negotiated by the client due to the fact the Respondent was conducting more than one rating of the same client. Further, the Respondent during the hearing also provided that clients have more bargaining power in face of the competition faced by the Respondent and therefore, following a standard fee structure is not feasible. The stance of the Respondent in this regard is not sustainable as the credit rating companies are required to follow a standard fee structure. The Respondent is not held accountable in the matter however, is advised to ensure that no such instances occur in the future since the fee schedule is self-prescribed. The Respondent can provide cushion for concession on the rating fee but the same should also reflect in their fee structure available on the website.
- k. With regard to the semi-annual review of all outstanding ratings, the Respondent during the hearing provided that all corporate clients in the instance cases are contacted on quarterly basis and a set of information is sought as required. Further, the Respondent also submitted that a similar practice shall be adopted for financial sector clients. The stance of the Respondent is therefore, tenable therefore, no action warranted in this regard.
- l. With regard to the industry specific studies to be conducted by the credit rating company in compliance with Regulation 19(3) of the Regulations, the Respondent submitted that they do conduct industry specific studies by choice considering the number of its existing clients in a sector or in case there is a new development in a sector. Further, the Respondent during the





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hearing also iterated that the Regulations are silent on the number of such studies and about selection of sectors. The Respondent's view point in this regard is justifiable as the Regulations do not specify industries for sector studies or about the selection of sectors for such study. However, the Respondent is advised to update sector studies of at least those industries where it is maintaining clientele. Moreover, certain sector studies published on its website have not been updated since many years and hence should be updated accordingly.


- m. With regard to the requirement of Regulation 14(3)(g) of the Regulation wherein the credit rating company is required to disclose necessary information on its website, the Respondent during the hearing submitted that the missing information regarding Sukuk Issue by Hascol Petroleum is available in the annexure to the report which is available on their public website. The viewpoint of the Respondent is tenable hence, no action is warranted. However, the Respondent is advised to display such information where it is readily available to the reader to avoid any uncertainty.

8. Before deciding in the matter, it is imperative to highlight the importance of the function being performed by the rating agency and the sensitivity of the rating business. The capital markets, both equity and debt, place a lot of reliance on their ratings hence due care should be exercised. The measures prescribed through the Regulations are an effort on part of the Regulator to ensure that a credit rating agency takes due care while assigning ratings. Hence, it is imperative that the Regulations are followed in letter and spirit.

9. In the view of the foregoing and the admission by the Respondent, contravention of the provisions of the Regulations have been established in 7 instances. Therefore, in term of the power conferred under Section 159(5) of the Act, a penalty of **Rs. 800,000/-** is hereby imposed on the Respondent. The Respondent is advised to enforce the provisions of the Regulations in letter and spirit. The Respondent is directed to deposit the aforesaid penalty in the account of the Commission being maintained in the designated branches of MCB Bank Limited within 30 days of date this Order and furnish the original deposit challan to this Office.

10. This Order is issued without prejudice to any other action that the Commission may initiate against the Respondent in accordance with the law on the matter subsequently investigated or otherwise brought to the knowledge of the Commission.




(Shauzab Ali)
Commissioner (SMD)

Announced on October 16, 2019
Islamabad