



Stockbroker Entity Rating Criteria Methodology

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Summary

LRA's Broker Entity rating represents its opinion on the relative credit risk associated with a broker. LRA arrives at this opinion by evaluating the broker's business and financial risks, its competitive strengths, along with an assessment of its management quality and the operating environment. Given the inherent volatility of the industry, the assessment of the financial risk profile of a broker also focuses on ascertaining the sustainability of its business operations in stressful times. While several parameters are used, the relative importance of each of these qualitative and quantitative criteria can vary across entities, depending on its potential to change the overall risk profile.

Analyst Contacts

Momin Farooque
+92-42-3586 9504

Momin.farooque@pacra.com

Lanka Rating Agency Limited

No 145, Kynsey Road, Colombo 08
Phone +94 114 500099

The Pakistan Credit Rating Agency Limited Head Office

FB1 Awami Complex, Usman Block, New Garden Town,
Lahore
Phone +92 42 3586 9504

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1. Introduction

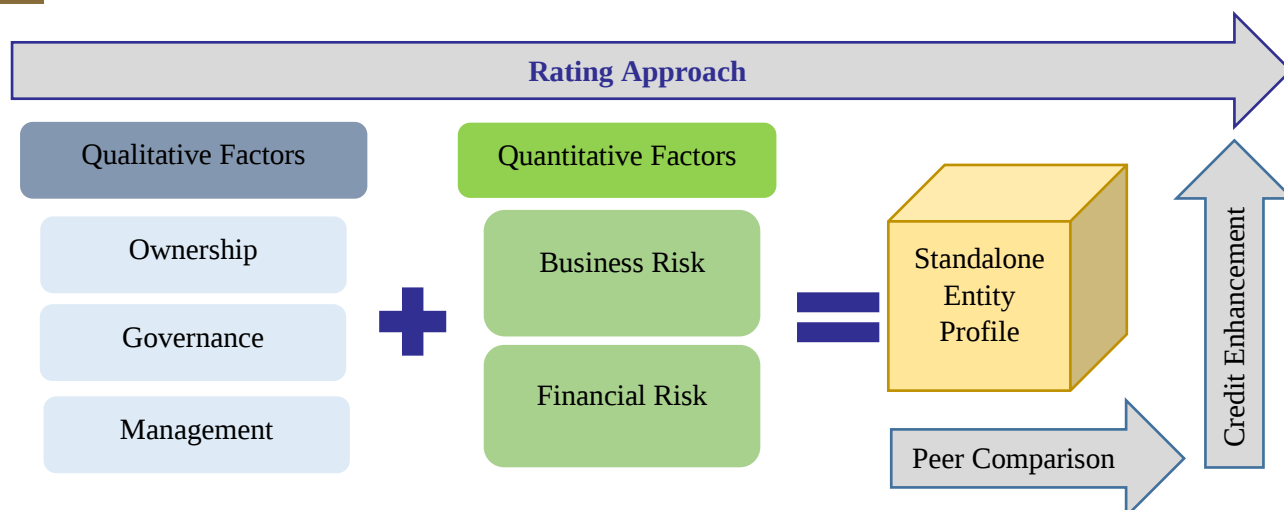
1.1 Scope: This credit rating methodology applies to stockbrokers. Stockbrokers are regulated by Securities and Exchange Commission of Sri Lanka (SEC). Further, stockbrokers need to adhere to the Trading Participants Rules of the Colombo Stock Exchange (CSE). Stockbrokers should meet minimum Shareholder Funds and minimum Liquid Capital. The two categories of stockbrokers specified by Colombo Stock Exchange are Trading Members and Members.

1.1.1 Stockbrokers provide free of charge services such as financial advice or research to its clients.

1.2 Rating Framework: LRA assesses brokers on a range of quantitative and qualitative factors, specifically Organizational Profile, Ownership, Governance, Management, Business Risk, and Financial Risk. No single factor has an overriding importance, and all factors are reviewed in conjunction. Quantitative factors often do not portray a holistic view of an entity, hence LRA employs a balance of both quantitative and qualitative factors in its analysis. This balance is maintained to ensure comparability of other ratings over time. The quantitative factors assist in achieving objectivity in the rating process, while the qualitative factors provide insight on a brokerage's ownership, governance, and management capabilities, which determine their capacity to sustain and enhance the quantitative aspects. Together, these factors establish a comprehensive understanding of a brokerage's performance and potential for growth.

1.2.1 The main objectives of this rating methodology are to understand the business model of a broker (and its inherent risks), evaluate the management's strategy, assess the local macroeconomic environment, and analyze the developments in the securities industry. Another key consideration under the broker entity rating methodology is the relative positioning of the broker in comparison to its industry peers and competitors.

1.2.2 LRA's rating process does not include an audit of a broker's financial statements. However, it does examine the existing control environment to establish the accuracy of the broker's financial statements and their reflection of the financial performance and integrity of the balance sheet. LRA also makes necessary adjustments for comparability between the financial data of different stockbrokers and establishes a "peer group" of comparable stockbrokers to conduct sufficient analysis of stockbrokers. The overall assessment culminates in the assignment of a long-term and short-term credit rating to a stockbroker. Information on the distinction between the long-term and short-term ratings and the relationship between them may be found in LRA's Criteria document titled "Correlation between Long-term and Short-term Rating Scales".



2. Profile

2.1 Background: LRA reviews the background of the stockbroker to understand its evolution from inception to where its current position. LRA analyzes the methods employed by the broker to achieve its desired expansion. LRA looks at the progress of the stockbroker from its historical performance, which helps in determining the ability of the stockbroker to successfully execute its strategies. A significant factor here for LRA is to assess whether the stockbroker has achieved its expansion through organic growth or acquisitions. Additionally, the source of funding utilized for achieving the growth is also examined critically.

2.2 Operations: The assessment of a stockbroker's operations depends on its business and its ability to extend credit to its Clients. Understanding the operations helps LRA identify potential business risks a stockbroker could face, its ability to safeguard assets from these risks, and its ability to attract and generate new business. LRA reviews the diversity and geographic scope of operations, the strength and quality of the stockbroker's business model, licenses, standard operating procedures, policies, protocols, and product offerings. The size of a stockbroker may be an important factor if it provides significant advantages in terms of operational efficiency and competitive position. Moreover, LRA evaluates the customer experience in dealing with the Stockbroker company, taking into account factors such as the quality of the trading platform, information accuracy, and efficiency in order execution.

3. Qualitative Factors

3.1 The qualitative assessment helps establish the sustainability of the rating in the foreseeable future. Qualitative considerations refer to rating factors that do not pertain to an entity's business or financial risk. They focus on internal processes, people, and systems, and are thus essential to incorporate in a forward-looking rating approach. This section provides a brief overview of how LRA factors in qualitative considerations to its assessment, insofar as they can impact an issuer's ability to meet financial obligations. LRA's detailed approach undertaken to conduct qualitative analysis is documented in its methodology titled "Qualitative Considerations".

3.2 Incorporating the potential impact of qualitative considerations into the rating opinion can be challenging as they are inferred or estimated based on information which may be unstandardized or difficult to quantify. This requires some degree of subjectivity and analyst judgement, supplemented by LRA's own experience and the experience of the underlying entity (or other entities with similar risks). The three factors underlying LRA's

qualitative analysis at the entity level include: Ownership, Governance, and Management. The scope of analysis for each category is briefly described below.

3.3 Ownership: The analysis of ownership is driven by the risks pertaining to the structure and stability of the entity's ownership, the key owners' experience and prowess in the securities industry, and the owners' willingness and ability to extend extraordinary financial support in distressful circumstances.

3.4 Governance: This section analyzes the risks pertaining to a stockbroker's Board of Directors' role in establishing a robust oversight and control framework to ensure appropriate management oversight, alignment between shareholder and management objectives, transparency in reporting and disclosures, and adherence to applicable regulatory requirements.

3.5 Management: LRA's analysis of management examines the risks pertaining to the proficiency of the management team of a stockbroker in executing strategy, maintaining strong information systems & utilizing them for decision making, and ensuring adherence to the entity's ethical and quality standards. Key factors looked into by LRA are organizational structure, the profile and business acumen of the management team, the management effectiveness, and the control environment in place. LRA's management analysis emphasizes an entity's present protocols to maintain robust information systems, key-person risk and turnover, and formulate strategic plans.

3.5.1 LRA examines the independence and effectiveness of the risk management function, the procedures and limits that have been implemented, the limits setting authorities, and the degree to which these procedures and limits are adhered to. LRA assesses a stockbroker's senior management's understanding of and involvement in risk management and examines the reporting lines in place. In recent years, there has been a noticeable improvement in the risk management systems of stockbrokers as a result of increasing guidance and supervision from Colombo Stock Exchange and Securities and Exchange Commission of Sri Lanka.

Credit Risk

- Risk emanates from the inability of clients to pay for the securities purchased on their behalf.
- LRA analyses the mechanism put in place by the stockbroker to minimize credit risk.
- Assessment of credit worthiness of client is crucial.

Market Risk

- Arises from adverse movements in investment values.
- Management's policy as to the proprietary book play a vital role in the overall assessment of the stockbroker's market risk appetite
- Poor market risk management or aggressive market risk-taking without mitigants would likely pressure a stockbroker's ratings.

Liquidity Risk

- Occurs due to insufficient funds to meet obligations.
- LRA analyses liquid investments against the stockbroker's funding base.
- stockbrokers with well defined policies of maintaining adequate liquidity are considered superior.

Operational Risk

- Operational Risk analysis include,
- Financial institution's definition of such risk,
- The quality of its organizational structure,
- Operational risk culture,
- Approach to the identification and assessment of key risks
- Data collection efforts, and
- Overall approach to operational risk quantification and management.

Reputation and other Risk

- May emanate from operational problems or failure in any risk management systems
- Results in withdrawal of deposits in case of strain on reputation.
- Difficult to evaluate but could adversely affect an institution's rating in cases where it is significant.
- Any regulatory non-compliance may lead to potential legal ramifications as well.

4. Business Risk

4.1 Industry Dynamics: The industry analysis focuses on the dynamics of the domestic capital markets over the past periods. Fluctuations and cyclical movements in capital markets are analyzed, and future projections are looked at based on this (especially regarding the medium-term outlook). Key data is the interplay of domestic and foreign investors, the risk and investment appetite of these investors, and the future expected trends of these aspects. Trading volumes and their concentration help in identifying the health of the industry. Domestic market dynamics are compared with other regional and global markets with the objective of identifying gaps and areas where the domestic market lags and the implications these gaps and lags have on the market. Moreover, industry positioning of significant market players is evaluated, while legal injunctions (current and forthcoming) are reviewed to form a view on whether the industry would experience a major shift in the medium-term.

4.1.1 The objective of LRA's business risk analysis is to establish the stockbroker's ability to sustain and grow its relative positioning in the industry while ensuring profitable operations. LRA also explores the possible risks and opportunities for a stockbroker that result from social, demographic, regulatory, and technological changes. It considers the effects of geographical diversification and trends in industry expansion, and other aspects, for instance if consolidation is required to maintain a competitive position. The analysis includes the role of the supervisory authority, its supervision of regulated entities, reporting requirements, and regulations relating to specific types of stockbrokers and to specific financial products.

4.1.2 Economic Risk: Economic risk refers to the potential impact of economic factors on the overall economy. LRA analyzes basic economic indicators of the country such as size & composition of the economy, performance of important sectors, geopolitical events, gross domestic product (GDP) growth, government influence, inflation, exchange rates, and trends in savings & investments. Other important parts of economic analysis are the positioning of the securities industry, impact assessment of economic risk factors on the industry, and the potential prospects within the industry.

Supply & demand in the securities industry heavily correlates with economic trends, thereby making brokerages heavily susceptible to economic risk. The extent and proportion of transactional income in the securities industry is fairly significant, inferring that in periods of economic distress – i.e., when investors are wary and refrain from trading activities – the survival of market players is significantly threatened. This threat especially pertains to smaller-scale stockbrokers reliant on transactional revenue.

4.1.3 Regulatory Environment: A well-regulated and supervised financial system is pivotal for the credibility and stability of stockbrokers - even when the operating environment becomes unfavorable. LRA pays close attention to the extent of vigilance by Colombo Stock Exchange and Securities and Exchange Commission of Sri Lanka, along with the extent of an entity's compliance towards regulatory frameworks. LRA's evaluation of the regulatory system involves evaluation of criterion related to capital and other countercyclical measures to absorb risk, and the extent of regulatory supervision and changes in response to the macro environment and prospective regulatory changes.

4.2 Relative Position: Relative position reflects the standing of the stockbroker among peers in the securities market. Institutions with stronger market standings demonstrate advantages arising from their comparatively larger scale and favorable market penetration. The stronger the relative position, the stronger the stockbroker's ability to sustain pressures on its business volumes and profit margins. The relative standing takes support from the stockbroker's market share and growth trend.

4.2.1 Market Share: Market share represents the stockbroker's penetration in its chosen markets. Greater size is advantageous as it provides the ability to acquire more business, have healthy pricing power, and better cost management. There are positive correlations between a stockbroker's size (both absolute and relative), and its market position and brand value. Larger entities exercise greater power over the pricing, while ensuring proportional profits. Small entities struggle to obtain business and have less flexibility in the cost structure, which can lead to their profits remaining low. While absolute size is important, the relative proportion provides a clearer yardstick to analyze the comparative strength of market players. The larger a player is in comparison to the average, the stronger its ability to reflect the aforementioned characteristics, and thus LRA believes that relative size would better capture the strength of a stockbroker's standing in a dynamic industry (one not characterized by concentration). Some variables observed by LRA to determine a stockbroker's true competitive position such as volumetric market shares, relative market shares of retail and non-retail clients, and trends in these market shares over time.

4.2.2 Growth trend: While evaluating the size, LRA also looks at the rate of growth of the securities' market, along with the growth in a stockbroker's fundamental metrics such as revenues, expenses, performing and doubtful trade receivables/investments, etc. Growth is important as it ensures that an institution continues to have the ability to meet industry benchmarks and maintain or improve its competitive position. As the industry grows, the scale of an institution's operations is expected to grow. This would reflect in the enhanced ability of stockbrokers to invest in human resources, upgrade the control environment, enhance the product slate, increase outreach, and improve the quality of products/services. To lag the industry's growth trend means shortages on these avenues, thereby pressurizing the stockbroker's market position. LRA monitors higher-than-industry

growth trends to understand the quality of the incremental business, including the impact on key business segments and if it has resulted in higher concentration due to added business. Higher growth while compromising the quality of the portfolio is perceived negatively.

4.3 Revenues: A stockbroker must derive income primarily from brokerage fees and interest on credit extended to customers. They are restricted from engaging in unregulated business activities without prior approval from the regulatory commission. This ensures focus on regulated activities and prevents potential conflicts of interest or misuse of client assets.

4.4 Cost Structure: Cost structure is analyzed to assess the amount of operational flexibility of stockbrokers in less favorable market conditions. LRA considers the extent of the variable cost base of a stockbroker, while also evaluating the stockbroker's performance and expense ratios relative to those of its peers. This assists in understanding whether operational costs have been contained as the stockbroker's asset bases and revenue streams grow. High expense ratios could be indicative of a significant fixed cost burden, and lower margins can indicate lesser flexibility in regard to inflation of operational costs. Overall, a low-cost base relative to peers offers stockbrokers greater flexibility to deal with competitive pricing pressures. The key measures that LRA looks at are the costs as a percentage of brokerage fee income, and costs as a percentage of total operating income. Non-mark-up expenses are also compared (where possible) with earning assets and the number of employees. That said, performance measures are not assessed in isolation as variations in them can be caused by business model differences and ongoing investments in the stockbroker's license.

4.4.1 Margins: LRA looks at the historical trend of a stockbroker's performance, the stability and quality of its earnings, and its capacity to generate profits. Wherever possible, LRA analyses the earnings for each of the stockbroker's business lines. LRA makes adjustments to a stockbroker's reported income statement figures, so that financial performance indicators are as comparable as possible from one stockbroker to another. The relevant ratios for this analysis are brokerage fee-based income to total income, and operating cost to brokerage fee-based income.

4.5 Sustainability: LRA evaluates the strategy of the management and the viability of the designed path to reach the brokerage's goals. Earnings prospects are monitored based on budgets and forecasts prepared by the stockbroker's management. A reality check is performed while analyzing underlying assumption taken by the management as well as management's track record in providing reliable budgets and forecasts.

4.5.1 Event Risk: Incorporating the risk of unforeseen events into a stockbroker's rating opinion is challenging. Events can be external (M&A's, regulatory changes, litigations or natural disasters) or internally driven (system breakdown leading to significant operational risk or strategic restructuring) and can lead to substantial rating changes. LRA applies its analytical judgment in assessing the likelihood of such occurrences, their potential impact, and assesses the stockbroker's track record, the expertise of its management team, and the level of financial discipline to incorporate into its ratings.

5. Financial Risk

5.1 In stockbroker companies, it's essential to maintain a clear separation between client funds and firm funds.

5.2 Credit Risk: The primary credit risk for stockbrokers arises when clients fail to repay extended credit, particularly if the value of shares drops below the amount of credit extended. This situation can result in a deficit where the credit extended exceeds the current value of the shares held as collateral. Therefore, at this point in

time, if the shares are sold, only a portion of the receivable can be settled. Unless the client puts cash towards the remaining balance, the firm will face credit risk.

5.3 Market Risk: Market risk, also known as unsystematic risk, arises from fluctuations in share prices, interest rates, commodity prices, and exchange rates. LRA's assessment of market risk is premised on an understanding that not all types of investments are equally exposed to market risk. LRA considers the extent to which a stockbroker is invested in liquid assets (notably short-term government securities). Greater liquidity is a proxy of lesser market risk exposure and is thus a positive consideration. A stockbroker's ratio of equity to investments is also an insightful metric for gauging market risk. This ratio assists LRA in observing the proportion of investments financed by a brokerage's own capital, as opposed to borrowed capital (and therefore less exposure to financing costs). LRA also observes a brokerage's tradeable investments relative to their total investments. The idea is that a greater proportion of tradeable investments out of total investments causes greater exposure to short-term market fluctuations - thereby increasing total market risk exposure.

5.4 Liquidity Risk: LRA's main aim is to identify the cushions present in a stockbroker's balance sheet against its committed liabilities. LRA investigates stockbrokers' ability to readily liquidate their investment portfolios to cover repayments against short-term liabilities. Evaluation of liquidity risk is a relatively straightforward computation – using metrics such as liquid investments as a percentage of the total funding base, alongside liquid capital balances to liabilities, liquid assets as percentage of trade related liabilities and short-term borrowings, et cetera. LRA places emphasis on the ability of a stockbroker to raise capital in times of short-term financial distress and liquidate assets in order to cover liability repayment in times of distress.

5.5 Capital Structure: LRA analyzes a stockbroker's ability to maintain the capital structure to formulate a view on the stockbroker's sustainability of operations. Funding sources currently available to a stockbroker, their level of utilization, and the composition of those funding sources (diversity and maturity profile) are assessed to view a stockbroker's financial health. The metric Net Capital Balance (NCB) is used to assess the overall health of the stockbroker and would reflect its size and rating. The minimum Net Capital Requirement for a stockbroker is Rs 35Mn.

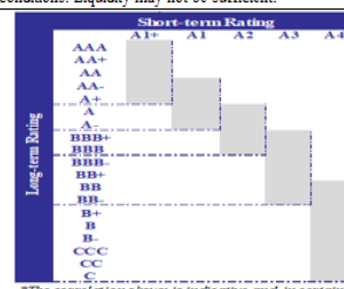
Information Required on Financial Risk

- Top 10 trade receivables and top 10 trade payables.
- Top 10 accounts classified under doubtful receivables
- Details of exposure limits for the stockbroking operations and measures taken by the management to ensure implementation of these limits
- Details of instances of margin calls during recent one year
- Authority limits of management as well as policy regarding total investment limit in said securities as percentage of equity
- Details of latest approved funding limits along with outstanding amount
- Internally approved list of eligible securities for margin financing (if any)
- Assess whether the company had maintained minimum net capital requirement
- Aging analysis of receivables
- Statutory reports filed in CSE/SEC and Central Bank (for FIU reporting)

Credit rating reflects forward looking opinion on credit worthiness of underlying entity or instrument. More specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long-term Rating	
Scale	Definition
AAA	Highest credit quality: Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments.
AA+	Very high credit quality: Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
AA	
AA-	
A+	High credit quality: Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to change in circumstances or in economic conditions.
A	
A-	
BBB+	Good credit quality: Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BBB	
BBB-	
BB+	Moderate risk: Possibility of credit risk developing. There is a possibility of credit risk developing particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
BB	
BB-	
B+	High Credit Risk: A limited margin of safety remains against credit risk. Financial commitments are currently being met, however, capacity for continued payment is contingent upon a sustained, favourable business and economic environment.
B	
B-	
CCC	Very high credit risk: Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favourable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
CC	
C	
D	Obligations are currently in default

Short-term Rating	
	Definition
A1+	The highest capacity for timely repayment
A1	A strong capacity for timely repayment
A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic or financial conditions.
A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic or financial.
A4	The capacity for timely repayment is more susceptible to adverse changes in business, economic or financial conditions. Liquidity may not be sufficient.



Outlook (Stable, Positive, Negative, Developing)
Indicates the potential and direction of a rating over the intermediate terms 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

Rating Watch Alert to the possibility of a rating change subsequent to or in anticipation of some material identifiable event with indeterminable rating implications. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating watch may accompany rating outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate. B) cessation of underlying entity. C) the debt instrument is redeemed. D) the rating remains suspended for six months. E) the entity / issuer defaults. Or / and f) LRA finds it impractical to surveil the opinion due to lack of requisite information

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

Surveillance: Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every 12 months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

Note: This scale is applicable to the following methodology (s):

- a) Stockbroker entity rating
- b) Corporate Rating
- c) Debt Instrument Rating
- d) Financial Institution Rating
- e) Holding Company Rating
- f) MicroFinance Institution Rating
- g) Non-banking Finance Companies Rating

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