



Credit Rating Company Limited

CURRENCY EXCHANGE COMPANIES RATING METHODOLOGY

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SCOPE OF CRITERIA

The criteria 'Exchange Companies Rating Methodology' (ECRM) applies to State Bank of Pakistan (SBP) licensed and regulated currency exchange companies established as a limited liability company with the scope and objectives of business as specified by the SBP from time to time.

To capture the peculiarity of the operations of Exchange Companies as distinct from the General Corporates and Non-Bank Financial Institutions (NBFI), the methodology, ECRM, while incorporating the governing framework and objectives of the Corporates and NBFI's methodologies, adds assessment areas and framework for Exchange Companies.

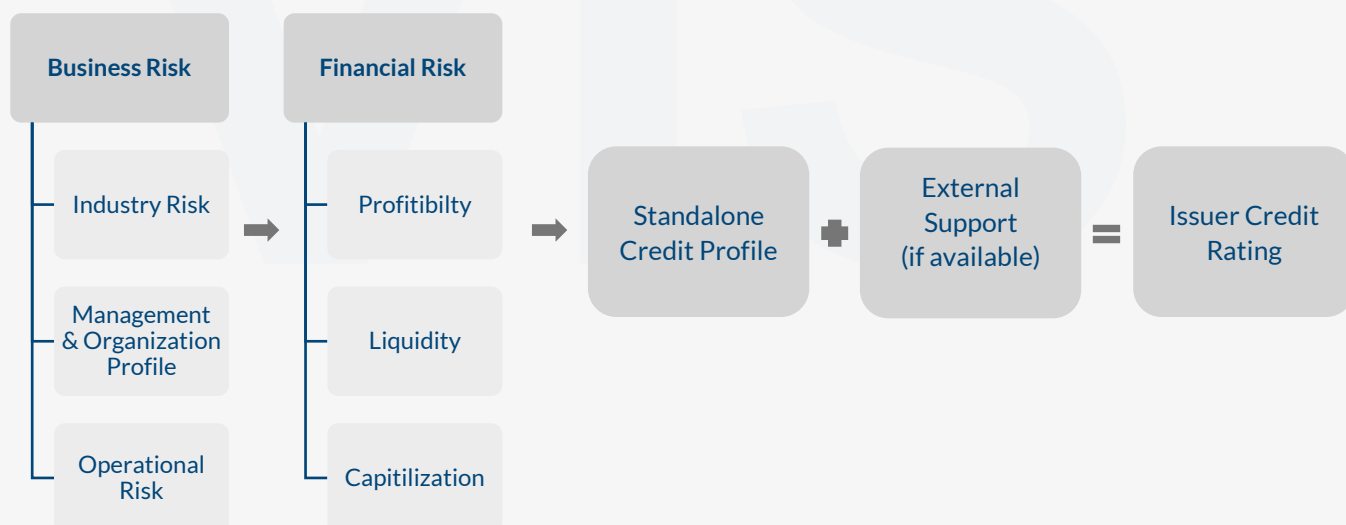
AN OVERVIEW OF RATINGS FRAMEWORK

VIS rating framework has two broad components: (A) Business Risk and (B) Financial Risk, with several sub-factors. Each area is assessed during the ratings process and the individual assessments are combined to arrive at the final rating. Weaknesses in one area may be offset by strengths in another or vice versa. While some factors such as financial ratios have clearly articulated benchmarks for each rating band, some areas require subjective assessment; this makes rating as much an art as a science.

The Business Risk assessment itself is performed at two levels; first at the industry level and then at the company specific level. The industry risk assessment focuses on the operating environment, degree of cyclicity and the strength of competitive forces along with the extent of capital intensity, vulnerability to technological change and level of regulatory interference in the industry.

At the company specific level, business risk analysis includes management quality assessment in terms of professional expertise in currency risk modelling, organizational structure with well-defined authorities and responsibilities, and operational risk factors focusing on strong internal control environment. The objective of this analysis is to ascertain the franchise value of the Exchange Company and the adequacy of operational systems, including KYC and AML controls, together with a review of quality of management and organizational structure.

Financial Risk analysis includes an appraisal of the historic and projected financials, risk entailed by the capital structure, level of profitability and, adequacy of cash flows to meet operational requirements and debt servicing obligations. The client and currency exposure limits definition and management is very important from the rating perspective. Finally, ratings take into account the external support available to the entity and may be enhanced based on the nature of support from sponsors / shareholders, associated companies etc. and the relative credit standing of the supporting entity.



RATING METHODOLOGY

A. BUSINESS RISK ASSESSMENT

Foreign Exchange Policy and its operations in Pakistan are formulated and regulated in accordance with the provisions of the Foreign Exchange Regulation Act, 1947 (Act). The objective of this Act is to regulate, in the economic and financial interest of Pakistan, certain payments, dealings in foreign exchange, securities, import/export of currency and bullion. Under section 3AA of the Act, SBP can authorize any company to deal in foreign currency notes, coins, postal notes, money orders, bank drafts, traveler's cheques and transfers.

As of financial year ended June 30, 2023, a total of 52 exchange companies (ECs) are functional which include 26 full-fledged ECs (ECAs) and 19 'B' category ECs (ECBs).

ECs are allowed to operate through branches, third party franchise agreements, payment booths, company owned currency exchange booths and temporary currency exchange booths. The scope of business of ECAs include buying and selling of foreign currencies, inward home remittances, outward remittances, export of foreign currencies other than US dollars, branchless banking as agents of authorized financial institutions, collection of utility bills and installation of banks' ATMs at their branches.

ECs are prohibited to engage in any other activity such as deposit taking, lending etc. Moreover, the scope of ECBs is restricted to buying and selling of foreign currencies and branchless banking as agents of authorized financial institutions. The Exchange Companies are authorized to deal with individuals (natural persons that are walk-in customers without establishing permanent/on-going relationship) only.

A. (i) Industry Risk:

Industry risk in currency exchange business is directly linked to the external sector strength or weakness of an economy, the extent of net availability of foreign currencies through trade, services and remittances; liberalization of currency convertibility status and the coverage of regulatory oversight on currency movement on revenue and capital account.

VIS believes business environment including political instability, economic downturns, or changes in government policies can have a significant impact on the operations and profitability of exchange companies and therefore are essential considerations for determining the creditworthiness of ECs. In addition, even though Exchange Companies often operate within a financial service niche, they are still exposed to the credit environment, regulatory requirements, behavior of local banks and the funding dynamics within any given geography. In addition, home remittance remains an important source of foreign exchange flows in the country. A significant portion of Pakistan's remittances come from countries in the Middle East, economic or political disturbances in these regions can impact the flow of remittances and subsequently the business of exchange companies.

A. (ii) Management & organization Profile:

The business profile assessment is based on a series of qualitative factors meant to assess the robustness of an EC's business model versus peers. Assessment of Organizational and Management risk entails the depth of coverage of internal control and compliance function in terms of addressing the extent of counterparty exposure and regulatory compliance risk. The strength and compatibility of the IT system with the business and regulatory environment is

important from the rating perspective. A strong external and internal audit along with updated documentation process adds value to assessment.

A. (iii) Operational Risk:

Operation risk remains heightened for EC's. Risks arising from failed internal processes, systems, fraudulent activities or inadequate procedures can lead to not only in penalties, sanctions and even closure of operations by SBP under the Exchange Company regulations but can also damage their reputation and result in loss of business. Exchange companies rely on their reputation to attract and retain result in a loss of business.

The consistency of regulatory compliances on a time line are important rating considerations, which are reflected in the ratings. These are largely captured from the review reports issued by external and internal auditor, compliance function of the company and by the regulatory agencies. The nature of regulatory actions taken by the regulator is important from the operational risk and compliance perspective. SBP also desires strict compliance of Anti-Money Laundering, Combating the Financing of Terrorism & Countering Proliferation Financing (AML/CFT/CPF) Regulations. The implementation, control and compliance of updated versions of these regulations is important from the rating and regulatory perspective.

The Market positioning of the Exchange Companies is dependent upon the number, type and strength of the counter party agreements for the inward and outward foreign exchange remittance. In these agreements, the extent of FX risk and liquidity risk on the Exchange Company as a counter party is important. Also important in these agreements is the guaranteed or semi-guaranteed periodic volumes particularly for inward remittances.

The service quality and speed of discharging its liability to the receiver of inward home remittances is among the important determinant of the franchise value of an exchange company. The competitiveness of exchange companies is determined by the conversion exchange rates offered (within the approved ranges given the regulator and the interbank buy rates) to the receivers by managing their spreads and commission rates with the counterparty remitter of FX.

The market positioning of exchange companies is also dependent upon regulatory approvals available for the Network of the Exchange Company comprising of Head Office, Branches, Franchises, Payment booths and Currency Exchange Booths allowed to each Exchange Company along with the geographical reach covered.

A larger own network and payment arrangements with authorized dealers of FX for credit to receiver account of home remittance would provide greater market coverage to the exchange company.

Important areas of Regulated Business of Exchange Companies are identified in Annexure 1 and risk identification and assessment wherein is important for rating purpose.

B. FINANCIAL RISK ASSESSMENT

The financial risk assessment is primarily driven by an objective analysis of the company's performance against predefined benchmarks. In undertaking this analysis, VIS not only looks at the absolute levels of ratios, we also focus on trends and compare these ratios with those of competitors. Financial ratios are also evaluated in context of a firm's business risk. A company with stable cash flows and favorable business prospects may take up added financial risk than a company having higher business risk.

The level of trading in inward and outward remittances are important considerations in rating assessment both from the point of view volume and value traded. Generally the exchange companies would not carry a net surplus position on own account on a trading day. The timely settlement of the inward and outflows is important from the market exchange risk point of view. All inward home remittances are required to be surrendered in the Inter Bank FX market and operational readiness for that is important rating consideration. The exposure limits and spread are governed by the regulatory guidelines given in the Exchange Manual and summarized below to understand the regulatory governance of exposure risks and spreads which have an impact on the financial operations of the company.

Exposure Limit for Conducting Business

- *The Exchange Companies are required to limit their exposure at the close of business each day at a level not higher than 50% of their capital base. The method to determine exposure shall be the same as has been prescribed for banks i.e. higher of the overbought or oversold positions at the close of day.*

Spread Between Buying/Selling Rates

- *Spread between buying/selling rates of US Dollar, Pound Sterling, Euro, Saudi Riyal and UAE Dirham shall not exceed one percent of their buying rate. For all other foreign currencies, Exchange Companies shall ensure to maintain a competitive spread. Further, it must be ensured that prevailing exchange rates applicable for sale/purchase of major foreign currencies are displayed through notice/display board at a prominent place in each outlet of the exchange company.*

Review of compliance of the above two important operational parameter regulatory limits is important in assessment of the ratings.

The total value of currency transactions processed by the company is a reflection of the relative market position of the entity in the FX market. Higher transaction volumes generally indicate a larger customer base and more business activity. The average amount of money exchanged in value transaction is also assessed as monitoring changes in this metric may provide insights into customer behavior and market trends.

Currency market risk remains intrinsic to the operations of currency exchange/trading companies. In addition, the risk of counterparty risk may also exist depending on the arrangements with different counterparties. Proper risk management, including setting risk limit and stress testing can protect these companies from unexpected financial losses and ensure their long-term viability.

B. (i) Profitability

The profitability of a currency exchange company depends on several factors and can vary significantly based on its business model, market conditions, risk management practices, and competitive landscape.

Spread management plays an important role in achieving the level of net profitability. Currency exchange companies typically make money by buying currencies at a lower rate (the bid price) and selling them at a slightly higher rate (the ask price). The larger the spread between these two rates, the more profit the company can make on each transaction. The expertise of forecasting FX movements here is important. Higher transaction volumes can also lead to greater profitability. Currency exchange companies often rely on a high volume of transactions to generate revenue.

It is important to note that currency exchange companies often operate on relatively thin profit margins due to competitive pressures. Therefore, efficiency and effective risk management are critical for long-term profitability of the Company.

B. (ii) Liquidity Management

Liquidity is a crucial aspect of the operations of currency exchange companies. I. Currency exchange companies need to have enough liquidity to accommodate customer transactions, which can vary in size and frequency. A sudden influx of large transactions can strain liquidity if not managed properly.. Access to a variety of financial instruments and counterparties can impact liquidity management. Supplementary local borrowings may be availed to manage their liquidity needs efficiently.

Market liquidity refers to the ease with which a currency exchange company can execute large transactions in the foreign exchange market without causing significant price movements. Major currency pairs like EUR/USD or USD/JPY tend to have high market liquidity, meaning that they can accommodate large trades without substantially impacting exchange rates. However, less commonly traded currencies may have lower market liquidity, making it more challenging to execute large transactions without affecting prices.

B. (iii) Capitalization

The capital structure of a currency exchange company refers to the mix of debt and equity financing it uses. Decisions about the capital structure can impact the cost of capital and the company's risk profile.

A well-capitalized currency exchange company is more likely to be financially stable and less susceptible to financial distress or insolvency. This financial stability is important for customer trust and regulatory compliance.

Capitalization profile becomes more importance with respect to currency risk management. Well capitalized companies are better positioned to manage currency risk. Currency market risk is measured by the following ratios: (i) Value at Risk (VaR): This estimates the potential loss in value of a currencies portfolio over a specified period for a given confidence interval. (ii)Currency Exposure Ratio: This ratio compares the net exposure in a foreign currency to the company's total assets. A high ratio indicates a high level of risk related to currency fluctuations. (iii)Currency Sensitivity Gap: This compares the difference between foreign currency assets and liabilities. A significant gap might expose the company to currency translation risks.

A well-balanced capitalization profile helps manage financial risk.

RATING SUPPORT FACTORS

Entity ratings may be enhanced on the basis of the extent of support from sponsors / shareholders, associated companies, etc. VIS takes into account how important the company is to the group, the relative financial health of the group and any explicit or implicit support to the company being rated. VIS seeks to analyze the particular instances in which assistance was required by the company being rated and the degree of support provided by the sponsors in the past. Evaluation of the financial strength of the group then becomes important to give any benefit in credit ratings including its franchise value, access to funds and diversification element.

In the event that a company / obligation is supported by two entities carrying independent credit risks, then the support provided is generally superior as compared to the situation in which only the stronger entity was supporting the company being rated. This concept arises from the viewpoint that the probability of both the supporting entities defaulting at the same time is lower than the probability of either one defaulting. Limited benefit of joint support is given to associated / group companies or companies in the same sector to ensure independent risk drivers.

Debt instruments may be notched from entity ratings on considerations of asset protection and ranking. For details on notching, please see 'Rating the Issue' by VIS.

THE RATING SCALE

Rating scale and Definitions may be accessed at (<https://docs.vis.com.pk/docs/VISRatingScales.pdf>)



ANNEXURE 1

REGULATED BUSINESS OF EXCHANGE COMPANIES.

Important Areas of Regulated Business of Exchange Companies are identified below; risk identification and assessment wherein is important for rating purpose.

Buy and Sale of Foreign Currencies

- Buy and Sale of Foreign Currencies from individuals in Ready value only and from/to other Exchange Companies in "Ready", "Tom" and "Spot" value dates.
- Exchange Companies may sell forward the export proceeds received from abroad in US Dollars to banks against the **export of permissible foreign currencies made on consignment basis** through cargo/security companies subject to adherence of terms and conditions as prescribed by SBP.
- "Sell" foreign exchange in Ready, Tom and Spot value dates, with banks as counterparty (**Interbank Market**).

Inward Home Remittances

- Inward Home Remittance business and such business shall be routed through foreign currency accounts of the Exchange Companies **maintained with banks in Pakistan**.
- Exchange Companies **shall surrender 100% of foreign currencies received** on account of inward home remittances, in equivalent US Dollars, in the interbank market on the same day.

Outward Remittances Business

- Exchange Companies are authorized to effect outward remittances only on personal account of individuals i.e. personal financial transactions and not those related to an individual's trade or business requirements.
- Exchange Companies are not allowed to effect outward remittances on account of trade related activities/payments against services/commission etc., whether on account of individual or on behalf of corporate clients.

Export of Foreign Currencies other than US Dollars

- Exchange Companies can export foreign currencies, with prior approval of SBP, other than United States Dollar (USD) and bring in equivalent USD in their foreign currency accounts maintained with banks in Pakistan.

Branchless Banking as Agents of Authorized Financial Institutions

- Exchange Companies are allowed to conduct branchless banking activities as agents of authorized financial institutions (Commercial/Islamic/Microfinance Banks) offering these services under Branchless Banking Regulations issued vide BPRD Circular No. 09 dated June 20, 2011.

Collection of Utility Bill

- Exchange Companies are allowed to enter into agreements with utility companies like WAPDA, KE, PTCL, SSGC etc. for collection of utility bills in PKR on their behalf.

Installation of ATMs

- Exchange Companies are allowed to install banks' ATMs for PKR at their branches as per the terms and conditions agreed upon between the respective bank and the Exchange Company without getting prior approval of the State Bank.

**Faheem Ahmad**

President & CEO, VIS Credit Rating Company Limited
Founder, VIS Group Chairman,
Vice-Chairman, Association of Credit Rating Agencies in Asia

Mr. Ahmad possesses 30+ year's 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.

**Javed A. Callea - Member**

Advisor

Mr. Callea is a professional in the financial sector with over 35 years of experience mostly in the financial institutions with certain exposure to service and infrastructure sectors in Pakistan. He has held the position of Chief Executive of a leasing company for 10 years. His core areas of expertise cover leasing, development financing, project management, investment & merchant banking, strategic investment management and real estate. Major financial institutions he worked for include Pakistan Industrial Credit and Investment Corporation, State Life Insurance Corporation, Bankers Equity, Crescent Leasing Corporation and Saudi Pak Ind. & Agri. Inv. Company. He has also served as Member Finance of Water & Power Development Authority of Pakistan and as member of the Inquiry committee on stock exchange crises in 2000 commissioned by the SECP. He earned his MBA degree from the Institute of Business Administration in 1974.

**Sara Ahmed**

Director - Rating

Sara Ahmed possesses 17+ years of experience in financial risk assessment and credit structuring. She has worked in Corporate Banking & Risk Management functions locally as well as internationally. Sara has been involved in the entity ratings of numerous corporate organizations as well as financial institutions besides being part of the Methodology and Criteria Development team. She holds a Master's degree in Business Administration from the Institute of Business Administration, Karachi (2001).

NATIONAL EXCELLENCE

INTERNATIONAL REACH

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 generosity 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.

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, VIS is positioned to aim for an international mark. In this regard, the global experience of our international affiliates and partners have 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, VIS continues its endeavour to remain an emblem of trust.

INTERNATIONAL

Affiliates

Islamic International Rating Agency – **Bahrain** – iira.com

Credit Rating Information & Services Ltd. – **Bangladesh** – crislbd.com

Collaborations

Japan Credit Rating Agency, Ltd. – **Japan**

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