PCR | PACIFIC CREDIT RATING

Risk Rating Methodology for Non-Bank Financial Institutions or Financial Services Companies

Concept	First and Last Name – Position	Signature	Date of signature
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1. Objective

To describe the risk rating methods and criteria used by PCRs of non-bank financial institutions or financial services companies (IFNB/CSF) that primarily engage in intermediation—that is, companies that channel funds from lenders to borrowers on their own account—or in auxiliary financial activities that are closely related to intermediation but are not classified as deposit-taking institutions.

2. Scope

These risk rating criteria are applied in the preparation of the risk profile (for a company) or business group risk profile (for groups, no support is considered). These are based on the risk assessment of the economy and the financial industry of the country under analysis. It is then supplemented with risk factors specific to the company being evaluated, such as market position, solvency, leverage, profitability, funding, and liquidity (specific performance factors). Finally, potential and extraordinary support or equity intervention by a government, company, or business group is considered a risk-mitigating factor. It is important to note that the final rating is assigned to the company and not to its potential debt issuances, which are rated under the PCR methodology for debt instruments.

The assessment may be conducted for non-bank financial institutions (NBFIs) or financial services companies (FSCs), that is, financial institutions that typically do not accept deposits and finance their investment or lending activities through the sale of securities. For example: *broker*, dealer, broker-dealer, *leasing* companies, mortgage companies (*e.g., residential mortgage / commercial mortgage*), consumer finance companies (*e.g., small-dollar loans*), student loan companies (*e.g., student loan*), *money* transfer companies (*e.g., money transaction processor*), microfinance institutions (*e.g., microfinance*), and financial consulting firms (*e.g., management consultant / financial advisor*). It also applies to non-bank financial institutions affiliated with the government.

The assessment may also be conducted for non-bank financial institutions or financial services companies whose financial activity relies heavily on fees as a source of revenue and which have limited balance sheet risk (IFNB/FSCs with limited balance sheet risk). PCR considers that the risk associated with these entities stems from their ability to generate cash or their inability to meet their financial obligations with their operating cash flow (a situation similar to that commonly found in non-financial corporations). The assessment incorporates other aspects from our corporate risk methodology, such as profitability, capital, leverage, and liquidity.

However, there are IFNBs where PCR will use other risk rating methodologies or criteria, such as for insurance companies, investment funds, or banks and financial institutions (the latter also applies to regulated non-bank financial institutions with substantial lending operations, global operations, large assets, and/or complex structures). In the specific case of trust companies, the fiduciary liability risk rating methodology[1]will be used.

In addition, the evaluated NBFIs/CSFs may be organized under different special legal frameworks depending on the business model and country; therefore, the evaluation must in all respects comply with such laws and/or regulations.

For any information, please contact us at metodologias@ratingspcr.com.

3. Definitions Stock

Market

A type of capital market operating worldwide where equities and fixed-income securities are traded in a structured manner through the buying and selling of tradable securities. It facilitates the channeling of short-, medium-, and long-term capital from investors to users. *E.g.: securities and exchange* **market Over-the-counter (OTC) market or private trading**

Over-the-counter (OTC) market, unorganized parallel market, or customized contract market where financial instruments are traded directly between two parties. This type of trading takes place outside the scope of organized markets. *E.g.: over the counter*

[1]See Appendix B: PCR Methodology Tree for the Financial Market

Non-bank financial institution

This is a financial institution that does not hold a full banking license and cannot accept deposits from the public. However, these nonbank financial institutions provide alternative financial services, such as investments (collective and individual), *risk pooling*, financial consulting, brokerage, money transfers, and cash management. They provide services not necessarily offered by banks, serve as competition to banks, and specialize in specific sectors or economic groups. *E.g.: nonbanking financial institution*

Broker // Brokerage firm

A person who, by virtue of their training, is involved in the trading and negotiation of securities and in the granting of loans. *E.g.: dealer*. // Entities authorized to operate on stock exchanges, both on behalf of their clients and on their own account. They may underwrite and guarantee securities issues, act as registrars, and serve as securities depositories. *E.g.: stock exchange dealer*

Broker // securities firm

An agent who acts by buying or selling on behalf of one or more principals. They are compensated by commission (brokerage fee). Some brokers may hold the status of public officials and even public notaries. *E.g.: Broker*. // A firm that may trade on the stock exchange, but only on behalf of its clients, and not on its own account. In addition, they may act as custodians of securities and manage investor portfolios. *E.g.: stock exchange broker* **Intermediation**

Activities carried out by banks, involving taking deposits from clients for a certain term and at a specific interest rate, and lending them to other clients for a different term and at a different interest rate, generally higher. // Activities conducted in financial markets—including stock and commodity markets—by various agents—*brokers, dealers, jobbers, market makers*, etc.—to connect buyers and sellers. *E.g.: Intermediation*

Financial market

A market where money and other financial assets are traded. Generally, these markets are not located in a specific place; rather, the term refers to the group of participants in the trading process, including the rules governing their operation. The actual object of the transaction is time, as purchasing power in the future is bought or sold. Its four fundamental components are: the money market, the government debt market, the capital market, and collective investment institutions. Depending on how the financial assets were issued, we can speak of a primary market or a secondary market. Depending on how buy and sell orders are executed, there are broker markets, dealer markets, and auction markets. *E.g.: financial market*

Financial industry

A group of institutions that act as intermediaries, attracting funds from savers and channeling them toward financing. They operate within an institutional framework regulated by a national authority; depending on the country, regulators oversee money market intermediaries, private banks, savings banks, credit unions, financial institutions, mutual guarantee societies, mortgage lenders, *factoring* companies, *leasing* companies, etc.; and public banks. *E.g.: financial system*

Banking

A type of business that engages in two fundamental activities: managing an economy's cash flow and financial intermediation. In the first, banks serve as the channel for payments and collections within economies, in exchange for fees for their services: transfers, check cashing, etc. For the second activity, they take in third-party funds in the form of deposits or loans—all of which are liability transactions—to carry out asset transactions in the form of loans to customers. The profit generated by this intermediation between depositors and borrowers stems from the spread between the cost paid for borrowed funds and the interest earned on asset operations, which compensates for the risk assumed by the financial institution. The origin of the word "banking" comes from the benches or tables on which money changers in the Middle Ages conducted their business. *E.g.: banking*

Credit risk

This is the probability that the interest and principal, or both, of a loan will not be repaid. There are methods for studying this type of risk: performance analysis and liquidation analysis. *E.g.: credit risk*

Foreign exchange risk

This refers to the potential for losses in the value of assets, liabilities, or commitments—which are reflected in off-balance-sheet accounts—as a result of fluctuations in the exchange rates of the currencies in which they are denominated. *E.g.: exchange risk*

Liquidity risk

This refers to the possibility of incurring losses due to a lack of sufficient liquid resources to meet one's financial obligations. In the case of banks, this risk is less significant today than in the past, due both to the development and integration of money markets and to the support provided by central banks as lenders of last resort. *E.g.: liquidity risk*

Market risk // systematic risk

It arises when interest rates or exchange rates move in the opposite direction to what was anticipated at the time a financial swap contract was entered into. // It is the risk associated with owning a stock, and it does not disappear when the portfolio is diversified with many other stocks. It is also called undiversifiable risk or market risk. It is the cause of market volatility. *E.g.: market risk // systematic risk*

Money laundering

Colloquially refers to the various methods used to legalize, in some way, funds that do not appear in the accounts and balance sheets available to the public, and that circulate in parallel commercial and financial transactions. The most common of these is applying for a loan with a foreign guarantee. *E.g.: money laundering*

4. Basic conditions

The PCR acknowledges that there are various types of financial institutions or companies offering different types of financial services that operate within the same financial intermediation market. Some specialize in financial intermediation or securities intermediation, while others—more complex entities—engage in both types of intermediation. However, it should be noted that not all assume the same risk, and not all are subject to the same degree of supervision or benefit from the advantages offered by strong and prudent regulation. Banking financial institutions (BFIs, those that accept deposits from the public) conventionally have access to central bank financing, which allows them to mitigate funding and liquidity risk; they have the lowest financing costs, enabling them to offer a wide range of highly competitive financial services; they face higher barriers to entry, which creates a more concentrated market; and are subject to extensive supervision, which allows them to earn greater trust from their investors and depositors. On the other hand, non-bank financial institutions (NBFIs, which do not accept deposits from the public) typically face greater risk compared to commercial banks [2]since, contrary to the above: 1) they lack access to the central bank, 2) they face greater competition and even compete with the banks themselves, 3) their operating environment has lower barriers to entry and their regulation is less comprehensive. In general, NBFIs pose a greater risk than banks because they are exposed to volatility in stock and over-the-counter markets, given their dependence on the liquidity levels of these markets when seeking to liquidate assets.

With regard to geographic scope, when an IFNB operates in more than one country[(3),]PCR assigns a rating that reflects the economic risks of the country in which that rating is valid, regardless of the domicile of the rated company or security. However, to estimate the overall risk level of the investment portfolio, the appropriate tool is the calculation of the Weighted Average Fundamental Risk (WAFR) indicators [4] . The calculation method consists of averaging, within each investment category, the different individual risk levels of the equity, fixed-income, and other assets acquired by the IFNB, weighted by their relative share of the total invested in each type of security.

Depending on each country's regulations, IFNBs/CSFs may be permitted, in addition to their primary business activities, to engage in other types of financial activities such as providing advice, supplying information, offering trading consultancy, structuring portfolios, and conducting

2During the Great Recession of 2007–2009, 63 financial institutions in the United States were taken over or acquired by another financial institution, nationalized by the government or central bank, or declared insolvent or liquidated. Of this total, 30 were nonbank institutions that were affected more severely than banking institutions.

3For example, MILA is the result of an agreement between the stock exchanges and depositories of Chile, Colombia, Mexico, and Peru. It is considered the Pacific Alliance Securities Market. Four countries, one market.

[4] For further reference, see the investment fund risk rating methodology established by PCR.

underwriting[5] , they could even engage in specialized investment banking activities, among others aimed at further developing their financial markets. In any case, PCR will always identify their greatest risk and may assess incremental risk using other current methodologies or criteria.

5. Specific Conditions

Methodology

PCR's rating approach for this type of institution employs analytical criteria that incorporate both quantitative and qualitative factors. The assessment begins with a preliminary analysis of the country's economy and financial industry to determine, as a first step, the baseline rating. At PCR, the Financial Industry Rating Methodology (ERIF) is used to conduct this assessment, which generally incorporates the development of the macroeconomic environment, the influence of government oversight, and financial market regulation, while also considering potential existing emergency support mechanisms for the system, such as funds, required protection insurance, or monetary policy practices implemented by central banks[6] . The Q-value and its resulting equivalent rating[7] in this assessment serve as the starting point for the rating of non-bank financial institutions or financial services companies.

As mentioned in the previous section, deposit-taking financial institutions are typically firms that mitigate risk by benefiting from regulatory requirements, privileged access to direct financing from central banks, strong and prudent supervision, and lower competitive risk. Non-bank financial institutions (NBFIs)/securities firms (SFs) conventionally lack access to central bank funds, face less rigorous or even limited supervision, and face greater competitive risk; therefore, NBFIs/SFs face higher risk and may be subject to an adjustment toward higher risk depending on their specific operating environment (subsector), thereby resulting in an adjusted baseline rating.

Performance-specific factors derived from the particular characteristics of the entity being rated are then applied. These factors may contribute to or detract from the adjusted base rating. The specific performance factors are management, competitive position, capacity for operational risk management, and the financial profile, which includes capital, leverage, funding, liquidity[(8),] and asset quality. These criteria are not exhaustive but constitute a general framework.

Management refers to a concise and primarily qualitative analysis of aspects of the institution's corporate social responsibility and corporate governance, based on sustainability indicators. Competitive position assesses the strengths of the company's business model relative to its main competitors, considering business growth and its short- and long-term objectives. Operational risk management is assessed based on the impact on the business's risk profile resulting from inadequate management of human resources, processes, or technology, which may also lead to financial losses or a loss of customer confidence. The financial profile analyzes capital adequacy, leverage, funding, and liquidity to

[5] In the case of IFNB/CSF with limited balance sheet risk, the assessment of profitability, capital, leverage, and liquidity is conducted in accordance with our risk rating methodology for short-, medium-, and long-term debt instruments, preferred shares, and issuers (PCR-MET-P-012, currently in effect for the corporations group). In Ecuador, this corresponds to the risk rating methodology for debt securities.

[6] Thus, for example, we are seeing in several countries that central banks are competing for resources and generating a *crowding-out* effect, causing local interest rates to rise and leading to a perception of higher risk, which is reflected in the financial industry's assessment—that is, in the baseline rating.

[7] See methodologies for the financial industry risk assessment (ERIF). In general, the ERIF is applied using data from financial institutions rated and unrated by PCR. This assessment seeks to incorporate a representative sample of the financial industry without discriminating against the type of entity, whether banks, cooperatives, mutuals, finance companies, savings banks, savings and credit societies, mortgage lenders, factoring firms, or other types present in the markets where PCR operates. Furthermore, the financial industry risk assessment takes into account the impact of non-bank participants and the impact on the real sector, that is, on non-financial business sectors.

[8] The assessment of capital, leverage, and liquidity is conducted in accordance with our risk rating methodology for short-, medium-, and long-term debt instruments, preferred shares, and issuers (PCR-MET-P-012, currently in effect for the corporate group). In Ecuador, this corresponds to the risk rating methodology for debt securities.

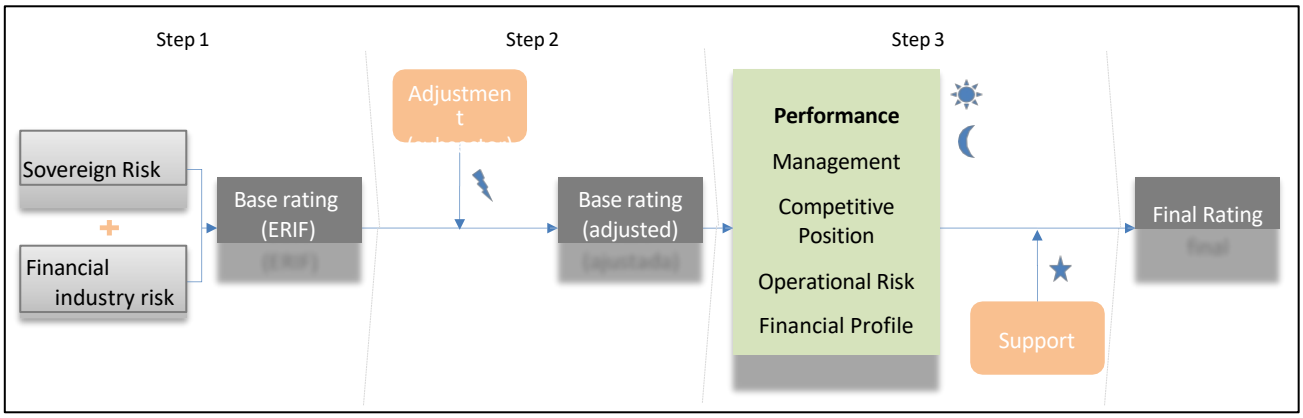
absorb potential losses, a capability that provides protection to major creditors while the business remains operational. Finally, the PCR credit risk analysis approach considers risks arising from on-balance-sheet activities, such as the investment portfolio. This yields the individual risk profile of the rated company.

Finally, prior to assigning the final rating to IFNBs/CSFs, we consider our assessment of potential external financial support[9], for example, from a corporate group, a related company, or the government. To this end, we verify that such support exists and can be provided to determine whether it is substantial, moderate, or nonexistent.

The following are the main criteria that must be examined:

- Operating environment (subsector)
  - Level of competition, growth, and outlook
  - Barriers to entry
  - Regulatory framework
- Management
  - Property characteristics
  - Management experience and capabilities
  - Other corporate governance variables
- Competitive Position
  - Market Share
  - Business Model and Competitiveness
  - Business stability and diversity
  - Profitability and operational efficiency
- Operational risk management
  - Risk management policies and mechanisms
  - Management and exposure to counterparty risks
- Financial profile
  - Capital adequacy
  - Leverage
  - Funding and liquidity
  - Credit risk

The following diagram summarizes the methodology used to determine the final rating.



a. Operating Environment (Subsector)

This part of the analysis aims to determine the incremental risk[10] of the subsector in the event of adverse economic or stock market events. The relevant variables regarding

[9] Occasionally, this interdependence relationship is negative.

[10] Incremental risk relative to the risk faced by a deposit-taking financial institution or the risk of the industry as a whole; that is, the risk faced by an IFNB/CSF is expected to be greater than, or in specific cases equal to, that of the system.

The criteria used for the assessment are those determined by the rating agency based on the results obtained. Among the variables that may be considered—without this list being exhaustive—the following may be cited:

1) Level of competition, growth, and outlook
   The level of competition is assessed based on the number of new entrants to the subsector and the frequency of such entries, how many of these are independent, and how many are affiliated with traditional banking institutions. Typically, NBFIs/CSFs offer financial products and services that traditional banks do not offer or offer only to a limited extent, seeking to avoid such competition. The degree of substitution and secular shift of financial products and services with those from other industries is also assessed. The ability to overcome these challenges in the future is an additional factor in the analysis.

   Profit margins, their stability, and trends are factors that could encourage new entrants into the market. PCR understands that the subsectors in which non-bank financial institutions (NBFIs) and financial service companies (FSCs) operate are cyclical—that is, they are highly correlated with economic performance—and therefore the stability of margins depends heavily on each institution's ability to manage variable costs. The level of fixed costs and investment will depend on the nature of the financial product or service.

2) Barriers to Entry
   Common barriers to entry include regulatory requirements, economies of scale, customer relationships, access to capital, and technology. In general, in the markets where PCR operates, one would expect to find a very limited number of subsectors with robust barriers to entry. Even a company that has achieved a certain level of differentiation from the competition may still not be protected from new entrants with innovative strategies. To analyze the existence of barriers to entry, one must identify the number of participating firms offering a similar and competitive service in the subsector, assess the degree of fragmentation, and review price levels, among other factors.

3) Regulatory Framework
   In the markets where PCR operates, there is typically regulation covering the entire financial market. Furthermore, such regulation generally has a broader scope for financial institutions that accept deposits from the public or manage funds for a significant number of clients, aiming to be effective and prudent in order to mitigate risk and promote the development of the financial system. However, there are subsectors that do not benefit from certain rules, such as access to central bank financing, or others that limit competition or increase costs. Therefore, it is necessary to assess the existence of special regulations for the subsector, changes to current regulations that could have a financial impact on both revenues and costs, and determine whether there are rules that prevent additional risk.

Each of the variables included in this analysis must take on three values, distinguished from one another by the level of incremental risk (high, medium, or low), and in the case of events that produce greater risk, the most critical variables are considered.

With the set of variables or events determined for each scenario, an assessment is made of whether the operational environment (subsector) could add risk to that already considered in the baseline rating, thereby obtaining the adjusted baseline rating. In the event of higher risk, the increase will depend on whether the baseline rating (that of the financial system) is investment grade, where the risk spread is greater in *notches*.

b. Management

The PCR approach to analyzing corporate governance is based on the methodology for incorporating environmental, social, and corporate governance factors into risk rating reports (current PCR-MET-P-121).

In this section, the PCR analysis focuses on the criteria defined below:

1) Ownership Characteristics

The characteristics of the owners are analyzed, along with how these might affect the risk profile of the IFNB/CSF. We analyze who the owners are and the level of trust they inspire within the industry, the financial characteristics of the major shareholders, their business vision, objectives, and policies, the owners' influence on company management, transactions with related parties, the major owners' interests in relation to the company and the evolution of the business group to which it belongs, and the relative importance of the company within that group. Taking into account the financial strength of the shareholders and the economic group to which it belongs, a high financial strength rating will consequently indicate low risk.

The analysis also covers the composition of the share capital, the dispersion of ownership, the role of the General Shareholders' Meeting, the company's committees, and the strengthening of institutional capacity.

2) Management Experience and Capability

The characteristics of the administration and the capacity of management are analyzed. Variables to consider include the professional qualifications of directors or managers for decision-making and for addressing business-specific challenges, as well as the ability to analyze and propose changes to the company's competitive position. A high level of professional education and years of experience in the sector indicate low risk.

3) Other corporate governance variables

Other variables to analyze include the organizational structure, succession plans, the management and planning system, computerization, the control system, and the comprehensive risk management system. A good succession plan, along with the existence and implementation of policies and/or manuals that enable better management, will indicate low risk.

PCR also analyzes the dividend or profit distribution policy, capitalization strategy, as well as the owners' ability to manage, establish, and enforce corporate policies.

An equally important aspect is monitoring the risk that the company may be used, intentionally or unintentionally, for criminal activities, and how it seeks to prevent money laundering and terrorist financing (ML/FT) as part of its comprehensive risk management, with a particular focus on companies involved in international currency exchange. The absence or inadequacy of AML/CFT risk management exposes IFNBs/CSFs to serious types of risk, particularly reputational, operational, regulatory, and concentration risks. Currently, many regulators are taking robust actions to mitigate these risks and impose direct and indirect costs on those lacking the appropriate policies, procedures, and controls to mitigate them.

A joint analysis of these variables will conclude that the characteristics of ownership, governance, and management capacity, along with other factors, can be categorized into risk levels according to established weighting criteria.

c. Competitive Position

The basis for assessing competitive position is the business model and its competitive strength, stability, and diversity; additionally, the business's profitability may contribute to, limit, or even undermine its position. It should be noted that factors related to ownership and management characteristics have already been considered and analyzed separately and in detail due to their importance, and therefore will not be included in this section. To analyze the competitive position of the IFNB/CSF, the following variables will be evaluated:

1) Business Model and Competitiveness

The company's competitive advantage is assessed through an analysis of its business strategy and brand strengths. The business strategy is expected to be consistent with the organization's capabilities and market conditions (subsector). To determine the brand's strengths, its reputation—or lack thereof—is considered. Market share and growth in the market where it operates are also key factors. A price level higher than that of the competition and the company's relative capacity to develop and operate the business also demonstrate its competitive advantage.

2) Business stability and diversity

The assessment focuses on the predictability of the most significant business volumes in the face of potential economic and market fluctuations. The subsectors in which non-bank financial institutions (NBFIs) and credit unions (CUs) operate are considered to be inherently more volatile than the banking sector itself. The indicators that determine our view regarding stability and diversity are business line diversification (i.e., *business mix*), geographic diversification, customer concentration, revenue stability, and the past performance and future trends of market share.

3) Profitability and Operational Efficiency

The level of profitability, measured by its history and volatility, is a key factor; furthermore, it can be compared with the results of its main competitors based on information covering at least three years (including projections).

High volatility in results limits confidence that there is sufficient protection against potential losses. Profits derived from income generated by permanent resources and high flexibility in expense management are considered stable. The commonly used indicator is ROA, since IFNBs/CSFs may exhibit balance sheet weaknesses; for those that are prudently regulated[11], adjustments are made to credit and market risk-weighted assets. Furthermore, in the case of securities firms, the higher volatility of the securities market is taken into account, and when balance sheet risk is limited, EBITDA is considered as a profitability indicator, in accordance with the methods established in our rating methodology for debt instruments.

On the other hand, taking into account the core business, we analyze indicators that cover the most important aspects of management, focusing on the experience, performance, and potential of the IFNB/CSF in relation to the services it offers. The following indicators are evaluated:

- Productivity = Annual Revenue / Total Number of Employees
- Proportion of qualified staff = Number of people with a college degree[12]/ Total number of employees
- Forms of staff training
- Availability of information
- Types of managerial, financial, and accounting control tools used.

d. Operational risk management

In this section, the PCR analysis focuses on the criteria defined below:

1) Risk management policies and mechanisms

In the case of securities brokerage activities or service companies, where a minimal level of fixed assets is recorded on the balance sheet, operational risk is the primary risk faced by these companies. Operational risk covers a wide range of risks that go beyond mere operations. This risk includes elements of a very diverse nature, such as human error, failures in operating systems, or the inability to comply with regulatory requirements.

There are IFNBs/CSFs that process large transaction volumes through technological platforms, using both human and technological controls. This means that IFNBs/CSFs and their clients may be susceptible to losses resulting from operational deficiencies, such as system failures or inaccurate transaction processing. In this regard, a study of the organization is conducted, analyzing its structure and operational processes, its efficiency in decision-making (policies, strategies, compliance with legal and contractual obligations, and historical performance), its internal control tools and processes, as well as its technological support for information systems.

The analysis in this section is primarily focused on evaluating the following aspects:

[11] Greater availability of information is expected.

[12] Technical-level staff with proven experience may also be considered.

i. The policies and mechanisms that guide the execution of back-office activities, with an emphasis on process quality, security, and automation, as well as the policies and mechanisms used for decision-making regarding asset management, including investment policies and their implementation.
ii. Policies and procedures for operational risk control should include a review of manuals, experience, roles, responsibilities, and decision-making autonomy of those in charge of control operations; policies and procedures for compliance with internal or external audits; and for following up on or responding to observations and inspections conducted by authorities or involved third parties; as well as the control and management of information flows, among other factors.
iii. The quality of the technological infrastructure, established business continuity plans, as well as the capacity of processes to facilitate the generation and flow of reliable and timely information to managers and parties involved in each contract, as required.

Technology plays a fundamental role in various processes carried out by the IFNB/CSF. In this regard, it is vital that the institution have adequate integrated technological support (hardware and software) suited to the nature and pace of its activities. Likewise, it is important that it have a unit responsible for continuously evaluating the performance of information systems, in order to propose improvements to the systems, equipment upgrades, process redesign, among other things. In this analysis, PCR will evaluate the quality of the systems that support the processes, as well as the security standards assigned to them. Special attention will be given to the business continuity plans established to safeguard historical information.

Reviewing internal audit and compliance officer reports can provide a good understanding of how the IFNB/CSF manages this type of risk and allows us to determine whether the root causes were identified. Allocating capital to invest in systems and tools that are in some way related to improving and reducing operational risk is a good sign that management considers it important to keep this risk under control. The institution's organizational culture can also provide us with information about potential operational risk issues that may exist.

An entity's performance can be analyzed based on the scale and complexity of its operations, taking into account each of the qualitative factors mentioned above. Strong operational risk management may not improve the rating, as this is expected of a well-managed company, whereas weak operational risk management may limit or negatively impact the rating.

2) Exposure to and management of counterparty risks

In the course of their operations, some IFNBs/CSFs are exposed to counterparty risk, defined as the risk these institutions face if their counterparties default on one or more transactions, requiring them to cover such defaults with their own resources or recognize a loss on their balance sheets.

Counterparty risk is closely interrelated with other types of risk, such as market risk, liquidity risk, and operational risk. For example, in a securities brokerage firm, counterparty risk may arise when a client fails to meet their payment obligations or deliver collateral in connection with transactions conducted under a securities brokerage or commission agreement, third-party portfolio management agreement, or financial advisory agreement. These firms may advance funds from their own resources to clients to execute purchase orders, and must hold such securities as collateral until the funds are repaid; this is how the securities firm is exposed to the risk of client default. Additionally, other parties with whom the securities firm conducts transactions on its own account or on behalf of third parties may be involved, such as the trading system, the stock exchange, or the securities clearing and settlement system. In these cases, counterparty risk is likely to be related to a purely operational and temporary factor, and the counterparty's risk profile will be considered the lowest.

At this stage, the assessment conducted by PCR focuses on the counterparty risk management strategy employed by the IFNB/CSF. It analyzes the existence and implementation of policies and/or manuals that enable the identification, measurement, control, and monitoring of counterparty risk, in accordance with the institution's structure, size, and authorized activities.

Policies for controlling counterparty risk must include a review of the risk profile and payment capacity of the counterparties with which the IFNB/CSF conducts transactions; transaction limits per counterparty, so as to quantify the maximum exposure amount by type of transaction; procedures or mechanisms for preventing counterparty risk, such as closing positions or liquidating collateral, among others that the entity deems necessary to prevent the materialization of risk; the collateral requirements imposed by securities trading systems, stock exchanges, and securities clearing and settlement systems, as applicable; as well as recovery plans in the event of defaults, incorporating the necessary human, financial, and legal resources to execute them.

e. Financial Profile

At this stage, a quantitative analysis is conducted to assess the viability and sustainability of the institution's operations in the market over time. The assessment evaluates both the IFNB/CSF's ability to absorb losses using either its own capital or third-party capital, as well as its capacity to support strong business performance through effective funding and efficient liquidity management—both under normal business conditions and in potential stress scenarios. A joint assessment that considers expected cash flows is always included to determine the final rating.

In the case of non-bank financial institutions (NBFIs)/securities firms with limited balance sheet risk, the greatest risk lies in their ability to generate cash flow rather than in the amount of capital required to cover potential losses. It is in this regard that the analysis is conducted using guidelines derived from the methodology for debt instruments.

1) Capital Adequacy

The analysis begins with the risk of non-compliance with established capital standards and limits for IFNBs/CSFs operating under prudential regulation. It then focuses, in addition to the structure, on the size of capital relative to existing risks with a forward-looking approach, and a comparison is made with the diversity of risks faced, including operational risk. With regard to IFNBs/CSFs with limited balance sheet risk, the assessment pays considerable attention to their ability to build a solid capital base through retained earnings.

A higher capital ratio allows institutions, on the one hand, to absorb greater asset losses, and on the other, to be more flexible and take advantage of attractive opportunities when they arise. When capital levels are low, the institution's room for maneuver is much more restricted.

2) Leverage

When the balance sheet includes non-traditional assets or those types of assets that are highly likely to result in losses, that is, instruments with very little or unobservable liquidity or highly leveraged assets (e.g., assets that are difficult to securitize, with high capital requirements, unsecured commercial loans, subordinated debt, high leverage with real estate, and other high-yield assets that financial institutions would not typically take on), leverage analysis becomes particularly relevant and is performed using the debt-to-equity ratio. This calculation may take into account our expectations regarding capital increases, dividend or debt payments, share buybacks, new issuances, and other positive and negative transactions. Additionally, the indicator can be stressed by excluding the capital of subsidiaries that PCR believes the company would not be able to support in adverse scenarios.

For example, securities firms, which typically exhibit higher levels of leverage—given that their business model is more focused on generating capital through investment and brokerage strategies—are less capable of absorbing losses than other financial institutions with the same level of assets. These firms may hold assets with low credit risk, thereby underestimating their capital requirements; yet they could face greater risk when liquidating such assets. Also,

since securities firms are typically financed with short-term funds, high leverage would limit their credit rating.

In the general case of IFNB/CSF with limited balance sheet risk, and as will be mentioned in the general terms and conditions, the leverage level is analyzed in the same way as a corporate assessment, that is, through the debt-to-EBITDA ratio, operating cash flow relative to debt, EBITDA relative to interest expense, and the debt level relative to tangible capital (defined as total capital minus *goodwill*).

3) Funding and Liquidity

As a basic principle for assessing funding and liquidity, it is assumed that funding sources are stable and are used for assets with similar durations; furthermore, long-term sources generally finance less liquid assets, while short-term sources are used for assets that can be realized more quickly. After analyzing these aspects individually, expected cash flows are considered.

A stable source of financing could be secured by being part of a business group or affiliated company, with the recipient of the funding forming part of a broader strategy. It is expected that such a source be not only stable but also timely and committed; that is, the related company or business group must have the capacity and willingness to provide sufficient funds to cover liquidity requirements, must have demonstrated reliable support and commitment over time, and there must be no regulatory limitations or barriers to doing so. Direct access to central bank funds or government equity investment is also considered a positive factor. In the case of securities firms, greater diversity and wide availability of such sources are particularly important and viewed positively, as the firm may be exposed to more complex financial instruments such as derivatives or those traded in the *over-the-counter* market.

The liquidity analysis focuses on the IFNB/CSF's ability to withstand adverse economic and market conditions and its likelihood of weathering such conditions over an extended period. In many cases, the analysis is based on expected cash flow (12 months) and qualitative factors related to the management of liquidity requirements. Specific indicators are also reviewed, which are the same ones used for banking IFs (see methodologies for banks and financial institutions).

The analysis of expected cash flow is calculated based on a base-case scenario and various stress scenarios, with the latter also taking into account the probability of using committed lines of credit that are freely available. Breaches of *covenants* by any counterparty are also taken into account, as such situations could restrict the use of these lines. For another scenario, one may also consider the loss of access to unstable short-term lines, an increase in the most vulnerable assets, and the withdrawal of cash flows due to commitments, among other factors.

The management of the IFNB/CSF regarding its liquidity requirements may affect the company's ability to obtain cash flows, especially during times of crisis. Therefore, it is essential that IFNBs/CSFs have timely measures in place to detect deficiencies; in this regard, the criteria defined below will be evaluated:

- The following will be viewed favorably:
  - Clear strategies, policies, and procedures have been established to manage liquidity;
  - The company has an adequate process for measuring and controlling liquidity, establishing internal limits (in addition to those required by law) to control exposure;
  - Establish in advance the actions to be taken when limits are exceeded or warning signals are triggered.
- The following will be viewed negatively:
  - The lack of a formally approved liquidity policy;
  - The absence of limits on funding obtained from specific counterparties, products, or markets;

- The lack of tools for liquidity management and control, such as monitoring liquidity ratios, maturity ladders, concentration analysis, and limits;
- Inability to comply with the limits or objectives established in the liquidity policy.
- Senior management with limited access to information and decision-making escalation.

In the case of IFNBs/CSFs with limited balance sheet risk, liquidity is analyzed in the same way that PCR does for corporations. That is, general liquidity ratios, acid liquidity, and other considerations included in the methodology for debt instruments are used.

4) Credit risk

In certain markets, non-bank financial institutions (NBFIs) and securities firms (SFs) may be exposed to credit risk through fixed-income and equity investment portfolios. The PCR analysis assesses the extent to which the institution is exposed to this type of risk and how well it manages and understands it. The process includes a review of the quality of investment portfolios, in terms of the quality of the instruments, their liquidity, time horizon, concentration, and valuation methods. For this assessment, methodologies used by banks and financial institutions or by investment funds are used in a complementary manner.

Strengths and Limitations

The profile of the IFNB/CSF can be assessed by considering its strengths and weaknesses depending on its position within the subsector to which it belongs, thereby taking into account various enablers and/or constraints.

A key constraint is that when an IFNB/CSF exhibits significant weaknesses in capital and leverage, its ability to generate profits becomes more critical.

Also, in subsectors with strong and prudential regulation, where a more concentrated and stable market is expected, the competitive position of each participant is less significant than when regulation is less clear and quantitative analysis provides stronger signals of their strengths and weaknesses.

In the case of IFNB/CSF with limited balance sheet risk, superior operational risk management allows for a higher risk rating, as this is the primary risk it faces.

Determination of the Final Rating

The final rating will use the category assigned in the preliminary rating as a baseline, with the aim of maintaining or modifying it once the characteristics of the IFNB/CSF have been evaluated. An analysis of risk ratings for comparable institutions and a holistic view of the institution's credit profile are also considered, where its payment capacity is evaluated on an aggregate basis. The comparison is primarily made with institutions in the same (sub)sector and country where the rating will be valid.

Conclusion

IFNBs/CSFs are financial firms that primarily engage in intermediation—that is, firms that channel funds from lenders to borrowers on their own account—or in ancillary financial activities closely related to intermediation but not classified as deposit-taking institutions.

Although IFNBs/CSFs are often overshadowed by commercial banks in terms of business volume and asset size, they play an important role in areas and markets where the presence of commercial banks is limited. In fact, these types of institutions can increase competition and allow greater access to the financial market.

It is also considered that, in some countries, the small size of the IFNB/CSF sector may limit its systemic impact on the rest of the financial sector during times of crisis; however, such crises can have significant effects under certain circumstances, such as triggering a loss of confidence in deposit-taking institutions or through balance sheet linkages. Furthermore, the lack of effective regulation of IFNBs/CSFs can exacerbate the fragility of the system as a whole.

Rating Categories

- Financial Strength of Financial Institutions and Insurance Companies (FF)[13]

AAA	This rating applies to entities with the highest capacity to meet their obligations under the agreed terms and deadlines, which would not be affected by potential changes within the entity, the industry to which it belongs, or the economy. Risk factors are negligible.
AA	This rating applies to entities with a very high capacity to meet their obligations under the agreed terms and deadlines, which would not be affected by potential changes within the entity, its industry, or the economy. Protective factors are strong, and risk is modest.
A	This rating applies to entities that have a good ability to meet their obligations on the agreed terms and deadlines, but this ability is susceptible to slight deterioration due to potential changes in the entity, the industry to which it belongs, or the economy. Protective factors are satisfactory.
BBB	This rating applies to entities that have sufficient capacity to meet their obligations under the agreed terms and deadlines, but this capacity could be weakened by potential changes within the entity, in the industry to which it belongs, or in the economy. Protective factors are sufficient.
BB	This rating applies to entities that have the capacity to pay their obligations in accordance with the agreed terms and deadlines, but this capacity is variable and susceptible to deterioration due to potential changes within the entity, in the industry to which it belongs, or in the economy, potentially resulting in delays in the payment of their obligations. Protective factors vary widely depending on economic conditions and/or the acquisition of new obligations.
B	This rating applies to entities that have the minimum capacity to pay their obligations under the agreed terms and deadlines, but this capacity is highly variable and susceptible to deterioration due to potential changes in the entity, the industry to which it belongs, or the economy, potentially resulting in default on their obligations. Protective factors vary widely with economic conditions.
C	This category applies to entities that do not have sufficient capacity to pay their obligations under the agreed terms and deadlines, with a high risk of loss. There is a substantial risk that contractual obligations will not be paid on time.
D	This category applies to entities that lack the capacity to pay their obligations under the agreed terms and deadlines, and that are in actual default on these obligations, or are subject to ongoing dissolution, liquidation, or bankruptcy proceedings.
E	This category applies to entities that do not have sufficient information or whose information is not representative, which prevents the issuance of an opinion on their risk.

These categories may be supplemented, where appropriate, with the symbols (+/-) to indicate an upgrade or downgrade, respectively, of the rating achieved within the range of AA through B, inclusive. Additionally, local scales will be identified by adding a prefix in accordance with the identification assigned to each market[14].

[13] The code for the Financial Strength of banks and insurance companies (FF) is PCR-MET-P-570.

1[4] Based on ISO 3166-1 alpha-2, two-letter code system.

6. Appendices

Appendix A: Quantitative Indicators

Appendix B: PCR Methodology Tree for the Financial Market

Appendix A: Quantitative Indicators

Risk Dimensions / Indicators	Definition	Formula
General		
Sales	This is the amount a company has billed its customers for the delivery of goods or services. It is typically recorded when the goods are delivered and are no longer considered inventory.	*Ventas netas*
EBIT	Acronym for *"Earnings Before Interest and* Taxes." A widely studied microeconomic metric, primarily in fundamental analysis.	$EBIT = Ingresos - Gasto\ Operativo$
EBITDA	Acronym for "Earnings before interest, taxes, depreciation, and amortization."	$EBITDA = Ingreso\ Operativo + Amortización + Depreciación$
Interest Expense	This is the cost incurred by an entity for borrowed funds.	*Gastode interés*
Net Income	This is a company's total profit, calculated by taking its revenue and subtracting business costs such as depreciation, interest, taxes, and other expenses.	*Utilidad neta*
Activity		
Accounts Receivable Turnover	This is the speed at which accounts receivable are converted into cash. It is calculated by dividing the sales figure for the period in question by the average balance of accounts receivable during that same period.	$\frac{Ventas\ anuales}{Promediodecuentas\ por\ cobrar}$
Days Sales Outstanding	This is a measure of the average number of days it takes a company to generate revenue after a sale is made.	$\frac{365}{Rotaciónde\ Cuentas\ po\ cobrar}$
Accounts Payable Turnover	This is the rate at which creditors are paid. It is calculated by dividing the cost of sales for the period in question by the average balance of the accounts payable account during that period	$\frac{Compras}{Promediode\ cuentas\ por\ pagar}$
Days Payable Outstanding	This is a measure of short-term liquidity used to quantify the rate at which a company pays its obligations to suppliers.	$\frac{365}{Rotaciónde\ cuentas\ por\ pagar}$

Risk Dimensions / Indicators	Definition	Formula
Total Asset Turnover	This is a measure of how effectively the company uses its total assets to generate revenue.	$\frac{Ingreso}{Promediode\ total\ activos}$
Fixed Asset Turnover	This is a measure of the utilization of fixed assets.	$\frac{Ingreso}{Promediode\ activo\ fijo}$
Working Capital Turnover	This is the percentage of operating working capital relative to sales. Proper working capital management will prevent this ratio from increasing, which would indicate excessive cash tied up in working capital.	$\frac{Ingreso}{Promediode\ capital\ de\ trabajo}$
Coverage		
Interest Coverage Ratio	This is a measure that determines how easily a company can pay the interest on outstanding debt.	$\frac{EBIT}{Gastode\ interés}$
EBITDA Coverage	This is a measure of a company's financial sustainability, i.e., whether the company's profitability is sufficient to cover interest expenses.	$\frac{EBITDA}{Gastode\ interés}$
Debt/EBITDA	Measures the company's ability to pay its debt.	$\frac{Deuda}{EBITDA}$
Liquidity		
Current ratio	It measures a company's liquidity, or its ability to meet its short-term payment obligations. A ratio greater than one is generally considered to provide the company with a margin of safety in the short term.	$\frac{Activo\ Corriente}{Pasivo\ Corriente}$
Quick ratio	Measures the most immediate liquidity, as it excludes inventory, the least liquid of current assets.	$\frac{Caja\ +valores\ realizables\ +cuentaspor\ cobrar}{Pasivo\ corriente}$
Cash ratio	This is a more conservative measure of liquidity, as it does not include accounts receivable.	$\frac{Caja\ +valores\ realizablese\ securities}{Pasivo\ corriente}$
Cash conversion cycle	This is a measure that expresses the number of days it takes a company to convert raw materials into cash.	$Díasde\ ventas\ pendientes\ +Díasde\ inventario\ disponible\ -Díasde\ cuentas\ por\ pagar$
Solvency		

Risk Dimensions / Indicators	Definition	Formula
Debt ratio	It is a measure of the company's leverage.	$\frac{Pasivo\ total}{Activo\ Total}$
Debt-to-equity ratio	It is a ratio, expressed as a percentage, between the company's debt and its equity.	$\frac{Pasivo\ total}{Patrimonio}$
Debt-to-capital ratio	It is a measure of a company's financial leverage.	$\frac{Pasivo\ total}{Pasivototal + Patrimonio}$
Total capital ratio	This indicator calculates equity as a percentage of total risk-weighted assets and contingent liabilities (credit risk, market risk, and operational risk).	$\frac{Patrimonio\ efectivo}{Activos\ y\ contingentes\ ponderadospor\ riesgos}$
Valuation		
Earnings per share	This is the profit per share outstanding.	$\frac{Utilidadneta - Dividendo\ deacciones\ preferente}{Earningper\ share}$
Price-to-Earnings Ratio	This is a metric that shows how many times the earnings per share are reflected in the price of each stock.	$\frac{Preciode\ mercado\ por\ acción}{Utilidadpor\ acción}$
Profitability		
Gross margin	This is the ratio of gross profit to sales, expressed as a percentage of sales.	$\frac{Margen\ bruto}{Ingresos}$
Operating Margin	This is the ratio of operating profit to sales, expressed as a percentage.	$\frac{EBIT}{Ingresos}$
Net Margin	It is the ratio of net profit to sales, expressed as a percentage.	$\frac{Utilidad\ neta}{Ingresos}$
EBITDA Margin	It is a measure of a company's operating profitability as a percentage of its total revenue.	$\frac{EBITDA}{Ingresos}$
Return on Assets	It is the ratio of net income to total assets. It expresses the company's economic profitability, regardless of how the assets are financed.	$\frac{Utilidad\ neta}{Promediode\ total\ activo}$

Risk Dimensions / Indicators	Definition	Formula
Return on Equity	It is the ratio of net income to equity. It represents the accounting return on equity.	$\frac{Utilidad\ neta}{Promediode\ total\ patrimonio}$

Appendix B: PCR Methodology Tree for the Financial Market