Securities Firms Criteria

Sector-Specific Criteria

This criteria report updates the one published in 2015.

The criteria set out in this report supplement and are applied in conjunction with Master criteria for financial institutions.

Securities Firm Definition: India Ratings and Research's (Ind-Ra) definition of securities firms includes firms whose principal activities typically include securities broking (charging a fee to act as intermediary between buyers and sellers), financial advisory services, investment banking, and/or securities trading. The firms assessed under these guidelines may be organised under any of a number of legal frameworks, depending on the business model. Business models can vary significantly.

Firms whose primary or sole activity is advisory or, separately, pure interdealer brokers (IDBs), which trade on a matched principal or pass-through basis known as '"name give up"', and so carry minimal risk on their balance sheets, may be assessed differently from firms that engage in other businesses related to securities. These can include broking, trading, taking proprietary positions, mergers and acquisitions activity, merchant banking and underwriting, or a combination of any of these activities.

Key Highlights

Five Central Factors: Ind-Ra analyses five key elements of a securities firm, which reflect the master criteria for financial institutions (FIs). They are: industry profile and operating environment; company profile and risk management; financial profile; management strategy and corporate governance; and ownership, support and group factors.

Application Reflects Individual Cases: As stated in the FI Master Criteria Report, *Financial Institutions Rating Criteria (see Related Criteria)*, Ind-Ra does not use a pre-set 'weighting' for each of the above factors or for the various elements within each factor, as the appropriate weightings can change in particular circumstances. As a general guide, where one area is significantly weaker than others, this weakest element tends to attract a greater weight in the analysis.

This Criteria Report identifies the factors considered by Ind-Ra in assigning ratings to a particular entity or debt instrument within the scope of the master criteria. Not all rating factors in these criteria may apply to each securities firm or to each rating action. Each specific Rating Action Commentary or rating report will discuss the factors most relevant to the individual rating or rating action.

Issuer Ratings Generally Assigned: Ind-Ra usually assigns both Long- and Short-Term Issuer Ratings to securities firms. Ratings are assigned to the operating securities firm itself, to its parent holding company, or to both, largely depending which entity issues debt. Ind-Ra also assigns debt ratings.

Additional Analytical Considerations: This Criteria Report should be read in conjunction with the FI Master Criteria Report. Additional analytical considerations for securities firms beyond those considered in the FI Master Criteria Report and areas of analytical emphasis are covered in this report.

Limitations

These criteria incorporate the general rating limitations highlighted in Ind-Ra's FI Master Criteria Report and in the Definitions of Ratings and Other Scales pages under Ratings

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Definitions on Ind-Ra's Web site at www.indiaratings.co.in and augment them with additional limitations.

For example, as for other FIs, securities firms' reliance on credit-sensitive investors for funding exposes their ratings to material cliff risk (i.e., multiple downgrades of ratings), as investors quickly react to disclosures of events or when there is a sudden withdrawal of liquidity from the market. This contrasts with the gradual migration of ratings due to deterioration in financial performance or leverage increases that generally affect corporate issuers.

Industry Profile and Operating Environment

As stated in the FI Master Criteria Report, the starting point for Ind-Ra's analysis of securities firms is an understanding of the firm's operating environment. For securities firms in particular, exposure to asset classes, specific business lines and geographic markets in which the firm is active is an important consideration. For example, the risks of a firm active mainly in highly liquid securities in large developed markets will usually be very different from the risks of those trading in illiquid or less active markets. This is due to the higher volatility of those asset classes and potential need to fund them for longer.

Regulatory requirements for securities firms vary depending on legal form and continue to evolve. Regulations are often positive for creditors and therefore ratings to the extent that they restrict potential leverage, boost liquidity, improve transparency and make it uneconomical to engage in higher-risk activity. However, ratings may be negatively affected when regulations or taxation changes affect firms adversely. For example, trading restrictions or high capital charges on certain products can curtail activities or profitability and make businesses less viable.

More onerous regulations may also disadvantage smaller firms that may not have the scale to manage or afford the burdens of a particular regulatory regime. To the extent the new regulations affect a company's core products and become a rating driver, Ind-Ra will indicate this in its public commentary.

Regulatory changes in the securities industry can also result in business shifting to new or different market participants. For example, new regulations now encourage derivatives settlement through officially recognised central counterparties rather than securities firms.

Company Profile and Risk Management

The main considerations in Ind-Ra's evaluation of a securities firm's franchise and risk management mirror those described in its FI Master Criteria Report. However, some items highlighted in that report warrant additional emphasis or detail.

Ind-Ra's assessment of risk controls considers the breadth and sophistication of risk management systems relative to the risk profile of the business and the types of management reporting used, where these are available. This may help indicate how far risk controls measures permeate the organisation with respect to the key risks a typical securities firm may incur, such as credit, reputational, market, and operational risks.

Additionally, Ind-Ra attempts to understand the level of risk management engagement across the firm, the variety of committees and membership, as well as the independence and authority carried by risk functions. The backgrounds and experience levels of risk management professionals may also be considered.

In credit risk analysis for securities firms, emphasis is placed on counterparty/settlement risk and credit risk in any illiquid debt or loan positions they are holding.

Reputation is a key factor behind a securities firm's franchise and an important qualitative rating factor. Expertise and track record are important factors establishing and maintaining reputation. Product expertise and specialisation can create and improve the franchise value of

Related Criteria

Financial Institutions Rating Criteria, April 2019

Non-Bank Finance Companies Criteria, April 2019

Rating of Bank Legacy Hybrids and Subordinated-Debt, April 2019

Rating FI Subsidiaries and Holding Companies, April 2019 a firm. When available, Ind-Ra reviews external market data, which may include industry surveys, underwriting league tables, industry awards, and various industry publications, to assess each firm's market share and franchise value.

All else being equal, securities firms with a broad product offering across asset classes and geographies tend to have a better credit profile, than the firms with a niche focus. The size and breadth of the customer base are also important. The larger firms, with higher transaction volumes, usually have greater liquidity to offer in product supply and access to a broader range of products. Scaling of operations brings pricing advantages as costs are spread over a higher number of transactions. However, there is always room for niche products or geographic market specialists, and a general move to more exchange-traded products is opening up the securities markets to new entrants.

Ongoing, robust risk management is vital to most securities firm's survival; therefore, assessment of a firm's risk culture and management is a key factor in the ratings analysis. A pure advisory firm will have less risk exposure but be subject to greater profitability cyclicality.

Risks assumed are a function of the selected markets of operation, the level of proprietary trading relative to customer flow, participation in alternative fee-generating businesses and the characteristics of the client base (institutional, private banking or retail). Diversification may mitigate risks but it is important to differentiate the sources and dependence on diversification during extreme market events, when risks can become more correlated. Broad participation in markets, and/or the presence of a strong retail customer base, or other consistent fee-generating businesses, can support more cyclical or volatile businesses.

Market Risk

Although securities firms that do not hold securities on their balance sheets generally have only limited exposure to market risk, their revenue is heavily exposed to the volume of transactions in the market. Revenue may drop when market values decline or volatility is lower and increase when prices are rising or when volatility is higher. Similarly, even advisory firms are subject to the cyclicality of deal volume, which affects their profitability. Market risk on its own may not be a rating driver; however, poor market risk management or aggressive market risk-taking without mitigation (such as hedges) would be likely to put downward pressure on an institution's rating.

Some securities firms are subject to substantial market risk through proprietary trading and retaining (unhedged) investment positions. Risk may be taken in any market where trades can be done – from plain vanilla corporate bond trading to more specialised areas such as weather derivatives.

Collateral and hedging are frequently employed to mitigate market risk, but hedges are imperfect, and so some degree of market and credit exposure generally remains. As a result, both gross and net positions are considered in Ind-Ra's rating evaluation to the extent such information is reported. Ind-Ra considers how regularly and routinely a firm evaluates its market risk appetite and its systems capabilities in light of constant market developments. Maintaining leading risk-management practices requires regular updates and vigilance. Asset and geographic diversification can mitigate market risk, although correlation tends to increase in economic downturns.

In addition to evaluating the size and reasons for movements in reported risk numbers, Ind-Ra's analysis of market risk focuses on a firm's means of measuring and managing it. These usually include value at risk (VaR), stop-loss limits, concentrations and sensitivity, or stress testing.

Ind-Ra evaluates the appropriateness of risk measurements by comparison with actual trading losses incurred – historical VaR compared with actual loss data charts are a feature of most trading companies' risk reporting. Ind-Ra reviews actual trading results over periods, noting any trends, and compares individual firm performance with market and peer results. Ind-Ra applies its own stresses to VaR data reported by the firms and compares these with earnings and capital metrics to assess the firm's capacity to absorb the risks taken.

Reliance on VaR alone is insufficient to measure the complex positions and structures of many trading desks. VaR provides some information but is unreliable in abnormal market conditions – arguably the time it should become more relevant. When available, Ind-Ra also evaluates management's reports of specific products' risks, sensitivities and supplemental stress scenarios on position and consolidated bases. When available, Ind-Ra also reviews reports that include adjusted VaR using liquidity-stressed scenarios or replicate historical periods of stress.

In markets where volatility and liquidity issues can be extreme, greater emphasis is placed on the level of nominal/cash limits. Ind-Ra evaluates the use of stress limits, but this is not comparable across peers.

When possible, Ind-Ra assesses market concentration risk (by product, issuer/counterparty, industry, and country) in trading and investment portfolios and reviews management's oversight of aged inventory. Ind-Ra may also review policies with respect to collateral and margin calls, and the reasons for any changes made to these.

Market risk within investments such as merchant banking, private equity, and venture capital is heavily influenced by liquidity. Determining a fair value for these instruments can be difficult and vary widely based on internal assumptions, such as discount factors.

Where material, Ind-Ra reviews the valuation and accounting practices of the firms to determine degrees of conservatism and proper controls over the recognition of income. It also assesses funding for these investments and growth trends.

Operational, Litigation, and Reputational Risks

Ind-Ra's assessment of securities firms' operational risk focuses on investment in front-, middle- and back-office systems commensurate with the nature of the business, including new product development/implementation and systems upgrades. Backlogs of settlements, resolutions and customer complaints or a history of problems with the firm's custodian can be the indicators of insufficient back-office staff support. These challenges can be exacerbated for institutions that have undertaken material acquisition activity. For pure brokerage or advisory activities, where only a minimal volume of asset flows are held on the balance sheet, operational, litigation, and reputational risks are the main risks the companies face. These tend to be material for all specialised securities businesses.

Securities broking and trading businesses process large transaction volumes via technological platforms, with human as well as technological controls. This means that securities firms and their clients can be particularly susceptible to potentially substantial losses arising from operational deficiencies, such as systems failures, inaccurate trade processing, or limit breaches (such as rogue trading incidents). As a result, if Ind-Ra determines that a firm has a weak operational risk infrastructure or control environment, this will typically have a negative effect on the ratings.

Problems with systems occur more frequently with new product development and implementation and when firms undergo systems upgrades. Ind-Ra evaluates whether investment in front-, middle-, and back-office systems is commensurate with the nature of the business and whether appropriate disaster recovery procedures are in place and tested regularly.

The agency also reviews the securities firm's interaction with its custodians and the extent to which any problems have arisen.

Where Ind-Ra considers operational support and systems weak relative to the sophistication of, and risks taken by, the front office, the rating will be negatively affected. The thoroughness of regulatory review and the strength of regulatory control over a trading environment are also factored into the agency's analysis. Operational risk can potentially have a more pronounced effect on less diversified businesses, where an operational shortfall can result in a temporary or permanent damage to the company's core franchise.

Ind-Ra considers reputation risk a very significant rating factor. The agency expects (and regulators require) firms to have a rigorous development process and policies ensuring appropriate vetting of all risks. A securities firm's reputational risk can be mitigated by evaluating the suitability of product sales to corporations or individuals and ensuring that those corporations and individuals have appropriate understanding of the products]. A firm's reputation can have some positive influence on a rating; however, if damaged it may put greater downward pressure on the rating.

As with other risks faced by securities firms, litigation and regulatory risks can be cyclical and often rise following equity market declines, stress losses, or regulatory changes. The broking and especially IDB businesses are relatively litigious. Litigation risk is also a key factor in the securities advisory business. Ind-Ra reviews a firm's regulatory and litigation track record and its measures to pre-empt significant compliance or regulatory failures.

However, litigation risk on its own rarely has a ratings impact, and therefore, RACs and rating reports will rarely mention it, unless there is the potential for significant costs or reputational damage that could affect the ratings.

Credit Risk

The degree of credit risk among securities firms varies substantially. Some firms carry significant asset volumes on their balance sheets for more than a short period, and in cases where these are largely debt instruments or loans, with risks more akin to those of traditional banks, Ind-Ra's analysis of credit risk follows that described in its FI Master Criteria Report. Some securities firms also have exposure to credit risks through the extension of loans, or structured financing, and leveraged products through derivatives. Ind-Ra considers reserve coverage ratios, the adequacy of collateral and margin requirements and the ability to enforce security claims. The agency's focus is to determine whether the firm's capital is likely to be negatively affected due to inadequate reserve coverage levels. The management of non-performing assets and management's approach to restructuring and rescheduling impaired assets is also considered.

Counterparty risk is a key consideration for firms transacting in securities and derivatives. Ind-Ra expects investment-grade rated securities firms to have independent credit policies and scoring or rating policies for these exposures. However, credit risk is not significant for pure brokerage activity (as for some IDBs) or for firms that provide advisory services, rather than invest in securities transactions.

Settlement risk is still often the largest credit risk for trading businesses. Credit limits are generally established separately for settlement risk and long-term transactions. Ind-Ra determines whether firms have a credit risk department independent of the sales and trading desks that determines counterparty limits, actively monitors usage, and reports violations. Ind-Ra also assesses the credit quality of the main custodians used by the securities firm.

In addition to more standardised credit analysis for financial institutions, the analysis of credit risk at securities firms may also focus on: the sophistication of systems for calculating margin and collateral requirements and modelling sensitivity; the level of stress testing undertaken; and the extent of uncollateralised positions (particularly with non-investment-grade counterparties). Ind-Ra assesses the composition and quality of a firm's investment portfolio, its investment criteria, and its track record in, or appetite for, selling down large underwriting positions.

Ind-Ra's analysis of securities firms takes into account the grey area between market and credit risk for traded assets. Market opinion on credit risk can be as important as actual default and loss risk when assets cannot be funded to maturity and the company is dependent on being able to sell these. On the other hand, market risk can often morph into credit risk following stress events. In emerging markets, credit/settlement risk can still be significant. Ind-Ra assesses the level of "free of payment" deliveries (in contrast to payment on delivery), where payment may not be so readily forthcoming.

Financial Profile

The key elements in Ind-Ra's evaluation of most securities firms' financial profile are profitability, cash flow, funding and liquidity, and capitalisation and leverage.

Profitability

Ind-Ra analyses the profitability of securities firms in line with its FI Master Criteria Report. Unlike for banks, interest margins are not meaningful for securities firms, and instead the focus is on the sustainability of trading, fees, and commission revenue, particularly in volatile markets. To some extent, a firm's track record through prior economic downturns, its franchise, and diversification of businesses provide insight into the sustainability of revenue.

Ind-Ra assesses the correlation of revenue among various product lines and investments and in relation to market and economic developments. Diversification and stability of revenue through various market cycles, particularly during significant market stress events, are key elements of the agency's analysis. The agency also reviews cost controls, the flexibility and variability of expenses (with special emphasis on compensation policies), and the tracking of performance against peers and forecasts or expectations. Ind-Ra incorporates expectations on the strength and mix of a firm's business lines in its assessment.

Ind-Ra usually views proprietary trading and investment activity with caution due to the significant potential volatility it contributes to the revenue stream. However, the strength, diversity, and level of capital supporting it are also important considerations. It is often difficult to determine proprietary trading relative to customer flow, especially for market-making firms, although periods of weak customer flow may provide greater transparency.

Revenue streams dependent on relatively high-risk businesses are often supplemented with more stable operating revenue, such as asset management, clearing operations, or securities financings and clearing. Ind-Ra reviews the contribution of these business segments to determine stability, with a significant contribution considered a credit positive. However, due to the narrow profit margins of these businesses, they often require sufficient scale to influence results meaningfully.

Most trading revenue derives from mark-to-market pricing, which may or may not be realised in cash form. To help understand the reliance that can be placed on reported revenue, when possible Ind-Ra reviews the firm's assessment and reliance on internally developed pricing models and the basis of accounting for product lines that are highly dependent on determining market prices from a model or haircut due to exclusivity or liquidity issues. The agency attempts to ascertain the amount of revenue that depends on internal inputs and is model based.

Ind-Ra analyses expense levels and ratios by trend and, usually, relative to industry peers. The agency first assesses the variability of a firm's expense base as it relates to its business lines. For securities firms, compensation costs are usually the largest of these variable components, but flexibility is sometimes limited in a competitive hiring environment. Compensation expenses are often analysed as a percentage of net revenue. This "sizes" the costs relative to activity levels.

Ind-Ra evaluates the effectiveness of a firm's compensation – mainly its bonus – policy in controlling compensation expenses. This includes the extent to which bonuses are linked to company or individual performance, are spread out over time, or are paid in shares or options rather than cash.

Ind-Ra recognises the importance of retaining quality employees to maintain business flow. A firm's ability to do this is directly affected by its compensation policy. Compensation expense as a percentage of net revenue is an important ratio, but the business mix is an important consideration in evaluating this ratio. Specific business lines may require greater or lesser infrastructure and personnel support.

Ind-Ra evaluates non-staff costs as a percentage of non-interest expenses in aggregate and, where possible or relevant, by individual line items. The agency also considers the business mix of the firm in evaluating non-staff cost ratios. Although an abnormally high non-staff costs expense ratio or a rising trend may indicate a lack of management control over expense levels, low ratios may indicate insufficient reinvestment in systems technology and infrastructure to enhance productivity and sustain the firm's competitiveness, or to maintain good oversight of risk development. The challenge for the industry has been to control costs through market cycles due to the business lines offered.

Cash Flow

For some securities firms, such as IDBs or advisory firms, cash flow metrics generally used for non-financial corporate analysis are more important in rating analysis than standard FI measures of profitability and leverage. Firms with relatively few balance-sheet assets are more directly dependent on cash flows to meet their obligations. Cash flow metrics also become more meaningful as the source of repayment for outstanding obligations for securities firms whose ratings fall below investment grade.

Typical cash flow measures used can include fee-related earnings measures, EBITDA, gross debt to EBITDA, and EBITDA to interest expense. These measures are often adjusted for various analytical considerations, including, but not limited to, nonrecurring items, performance-related items, or other non-cash expenses (such as stock compensation). Given many securities firms with low balance sheet usage have a continual need to invest in technology development, the amount of operating cash flow generated to support capital expenditures is also considered.

For IDBs and some other securities firms, a large proportion of cash is usually tied up in subsidiaries for regulatory and operational purposes, so leverage and interest coverage (measured by EBITDA/interest expense) are best assessed at stand-alone holding company level.

Funding and Liquidity

A relatively high proportion of securities firms' borrowing and lending is secured by liquid securities collateral. Liquidity can evaporate when repo counterparties and prime broker clients retreat as a result of negative market stress events that create actual or perceived losses, regulatory investigations, or allegations of fraud. Although securities firms are not the only entities affected by changes to the acceptability of collateral, increasing haircuts, or material widening of a bid-ask spread, these factors can have a substantial impact on them due to the frequent dependence of securities firms on credit-sensitive funding sources, which makes their ratings much more sensitive to such changes. For securities firms with low balance sheet usage, funding, liquidity and coverage are primarily evaluated in the context of adjusted EBITDA to interest expense.

Ind-Ra assesses a firm's ongoing funding requirements and management including its funding diversity, debt maturity profile, liquidity status and the proportion of unencumbered liquid assets. One characteristic of a solid investment-grade firm is a high proportion of unencumbered liquid assets. Access to multi-institutional liquidity facilities is also a positive factor in the ratings. Funding and liquidity assessment may also include consideration of an issuer's compliance with any funding covenants, the extent to which compliance with such covenants fluctuates and management's ability to operate the business and obtain funding without being unduly constrained by covenant requirements.

One source of liquidity is the ability to rehypothecate (or on-lend) securities placed by other firms. Rehypothecation requires permission from the owners of the securities, and Ind-Ra assesses a firm's policy toward granting permission to other firms to do this in addition to assessing the extent to which securities placed with the firm are available for rehypothecation. Securities firms are usually dependent on the capital markets for very substantial amounts (if not almost all) of their funding, whether secured with readily available and liquid collateral or unsecured. Firms actively use counterparties to finance their trading positions and the debt markets for additional funds. Secured funding is obtained by posting securities collateral with central banks or other FIs.

The large securities firms also act as liquidity providers, providing short-term cash collateralised by liquid securities. In addition, securities firms participate in the liquidity of the securities market, lending and borrowing securities, and matching buyers and sellers. The firms prefer to use secured funding sources when economical, as growth can then be "self-financed."

Ind-Ra views financial flexibility as a critical component of the credit rating. The ability to survive market disruptions is directly related to a firm's stability of funding and risk appetite for high-yield, less liquid, or illiquid instruments. Securities brokers' assets typically consist largely of readily saleable financial instruments, which is a positive ratings factor.

The agency closely scrutinises the funding of illiquid assets, such as merchant banking and high-yield securities, fixed assets, and private equity, and monitors the extent to which they are funded by long-term debt and capital. Ind-Ra also evaluates any contingent funding requirements the firm may face, such as liquidity lines or backup facilities extended, or additional collateral calls that may be made on it if market conditions change.

Ind-Ra's understanding and monitoring of an issuer's compliance with any funding covenants, the extent to which compliance with such covenants fluctuates, and management's ability to manage this are also important factors for a securities firm's rating.

Capitalisation and Leverage

For those securities firms that maintain a substantial volume of assets on balance sheet or commitments that could require financing, Ind-Ra follows the capitalisation analysis described in its FI Master Rating Criteria Report. For those carrying relatively few risk assets, the assessment of debt coverage is based more on cash flows, as described under the Cash Flow section above. For securities firms that have a combination of businesses which have different degrees of balance sheet usage, such a retail brokers, Ind-Ra will typically evaluate both cash flow and balance sheet leverage ratios.

In addition to Ind-Ra's own suite of capital measures, a firm's capital management plans and, where relevant, an understanding how management views economic capital models are important to a securities firm's ratings. When relevant, Ind-Ra monitors regulatory capital ratios and capital covenant ratios to ensure the firm is not in danger of becoming non-compliant.

Ind-Ra uses gross leverage (total assets over Ind-Ra's core capital) and adjusted leverage metrics more commonly in the analysis of securities firms that are more balance-sheet intensive than in commercial bank analysis. The agency calculates an adjusted leverage ratio – total assets less reverse repurchase agreements (repos) over Ind-Ra's core capital – and net adjusted leverage, which deducts securities borrowed and reverse repos from total assets. (Ind-Ra's core capital is published common equity less goodwill and all other intangibles, less deferred tax assets, and other adjustments consistent with the FI master criteria; see Key Metrics for Securities Firms below). For institutions reporting under International Financial Reporting Standards, Ind-Ra makes further adjustments to leverage ratios where possible to incorporate netting arrangements on derivatives and repos.

These leverage ratios assess the extent to which the assets a firm carries on its balance sheet are financed by debt. Ratios based on reported assets are only a crude measure of real leverage, and Ind-Ra also uses regulatory risk-weighted ratios where available and carries out additional, generally more qualitative, analysis to compensate for the lack of any weighting of risks and the absence of any off-balance-sheet exposures in the total assets metric.

Management and Corporate Governance

Ind-Ra's assessment of a securities firm's management and corporate governance is carried out as described in the FI Master Criteria Report. The integrity and track record of management is an important part of the agency's analysis, together with the checks and balances imposed on management by the corporate governance structures. Ind-Ra places particular emphasis on evaluating the knowledge and experience of management and the board in the firm's main products.

Some securities firms are privately held or structured as partnerships. This can make insight into management more challenging and mean that managers who are also partners in the firm act as agent and principal at the same time, which may be positive or negative for creditors. It can be positive in the sense that the partner-managers may act prudently in the general interests of the company and take measured actions or potentially suffer the economic consequences of excessive risk-taking. Conversely, unchecked decision-making by individuals can be highly subjective, exposing the creditors to additional risk.

This personal interest in the outcome of transactions is encouraged more widely among securities firms by the structure of their compensation schemes for traders, with bonuses tied closely to profits made on deals done. Ind-Ra often analyses management and controls regarding compensation in these firms – with best practice based on an independent compensation committee and an established and consistent compensation policy that aims to align compensation with the medium-term interests of the company more than the short-term interests of the individuals.

Evidence of fundamentally weak management or corporate governance in a securities firm, which could make debt holders vulnerable to potentially significant credit losses, would have a negative impact on the ratings and will be highlighted in Ind-Ra's published analysis.

Holding Company

Some securities firms have holding companies, which may or may not be regulated. Most operating entities are regulated. Legally, in the absence of guarantees, issuance directly from the operating securities firm has a priority claim on operating cash flows and assets in the securities firm over issuance by the holding company. The payment of holding company interest and principal is often dependent on funds being upstreamed from operating subsidiaries. The holding company may also engage directly or have subsidiaries participating in other financial activities, which often carry a higher degree of risk than the regulated entities.

Based on the analysis of several factors, including holding company liquidity, double leverage, profitability, cash flow, and level of complexity, holding company ratings and debt ratings may be aligned with those of the operating subsidiaries or they may also be notched down. More detailed analysis of holding companies is made in Ind-Ra's Criteria Report *Rating FI Subsidiaries and Holding Companies* (see under *Related Criteria*).

Common Ratios for Securities Firms

The table below lists some key metrics Ind-Ra may use in its analysis of securities firms. Those listed are not used for all firms and are not the only metrics used. Many of the other metrics listed in Ind-Ra's Financial Institutions Rating Criteria are also relevant to the analysis of some securities firms' business models. The idiosyncrasies of various securities firms' business models mean that a set of ratios uniquely relevant to a particular entity is quite possible.

Figure 1
Key Metrics for Securities Firms

	Definition	Securities firms to which typically applied
Capital and leverage ratios		
Equity/total assets (%)	Reported equity as a percentage of reported assets	Securities firms generally
Ind-Ra core capital (IRCC) to total assets (%)	Shareholders' equity, less hybrid capital reported as equity, non-controlling interests reported outside equity, less non-controlling interests not regarded as loss absorbing by Ind-Ra, less goodwill and all other intangibles, less ineligible deferred tax assets, +/- fair value of own credit risk, less first-loss tranches of retained off-balance-sheet securitisations, less life assurance/insurance company interests as a percentage of total assets	Securities firms generally
Ind-Ra eligible capital (IREC) to total assets	IRCC plus hybrid equity credit (0%, 50%, or 100%) as a percentage of total assets	Securities firms generally
Tangible common equity/tangible assets (%)	(Shareholders' equity - preferred stock - goodwill)/(total assets - goodwill)	Securities firms generally
Tier 1 risk-based capital ratio (%)	Ratio as reported to the regulator. The calculation is: capital as defined by the regulator as a percentage of weighted risks as defined by the regulator	Securities firms generally where available
Internal capital generation (%)	Reported net income less dividend as a percentage of reported equity at the start of the reporting period	Securities firms generally
Total liabilities/equity (%)	Leverage ratio showing total reported liabilities as a percentage of reported equity	Securities firms generally
Trading + investment securities/equity + security reserves (%)	Total securities as a percentage of equity plus any securities reserves	Companies with material trading portfolios
Adjusted leverage	(Total assets - reverse repurchase agreements)/IRCC and also IREC	Companies with material trading portfolios
Net adjusted leverage	(Total assets - reverse repurchase agreements - securities borrowed)/IRCC and IREC	Companies with material trading portfolios
Gross debt/equity (%)	Gross debt as a percentage of reported equity	Interdealer brokers
Gross debt/EBITDA	Gross debt/EBITDA, with adjustments for significant non-cash items such as non-cash compensation expenses	Interdealer brokers, advisory firms
Funding and liquidity		
Current assets/total assets (%)	Current assets as reported (generally those due within one year plus liquid securities) as a percentage of total assets as reported	Securities firms with material balance sheets
Current assets/current liabilities (%)	Current assets as a percentage of reported current liabilities	Securities firms with material balance sheets
Long-term debt/assets (%)	Long-term liabilities (over one year) as a percentage of total assets	Securities firms with material balance sheets
Senior debt/total assets (%)	Senior debt as a percentage of total assets	Securities firms with material balance sheets
Deposits/totals assets (%)	Customer deposits as a percentage of total assets	Securities firms generally
Liquid assets/total assets (%)	(Total assets - illiquid assets [as calculated by Ind-Ra – see below])/total assets	Securities firms generally
	Illiquid assets typically include high yield debt + merchant bank, private equity investments + emerging market + consumer loans + bank loans + goodwill + intangibles + non-investment-grade derivatives marked to market + other assets + non–investment-grade residual assets.	
IREC + adjusted debt/illiquid assets	(IREC + adjusted debt [includes non-equity hybrid allocation])/(illiquid assets)	Securities firms generally
Long-term funding sources/illiquid assets (%)	Equity and long-term borrowing as a percentage of illiquid assets	Securities firms generally
Liquid assets/short-term funding (%)	(Total assets – illiquid assets) as a percentage of wholesale funding due within 12 months	Securities firms generally

Figure 1
Key Metrics for Securities Firms

	Definition	Securities firms to which typically applied
Profitability		
Return on average equity (%)	Reported net income as a percentage of reported equity	Securities firms generally
Return on average assets (%)	Reported net income as a percentage of reported total assets	Securities firms generally
Operating profit/average equity (%)	Operating profit (pre-tax profit before nonrecurring and non-operating income and expense) as a percentage of reported equity	Securities firms generally
Pre-tax profit margin (%)	Net income before tax as a percentage of total operating revenue	Securities firms generally
Compensation/net revenue (%)	Compensation paid in the period as a percentage of operating revenue, isolated for brokers and traders compensation where possible	Securities firms generally
Operating expenditure/total revenue (%)	This ratio and the seven following ratios measure the importance of each of the components of operating profit, taking them as a margin of total revenue	Securities firms generally
Operating profit/total revenue (%)		Securities firms generally
Net commissions income/ total revenue (%)		Securities firms generally
Net trading income/total revenue (%)		Securities firms generally
Net interest income/total revenue (%)		Securities firms generally
Net brokerage/total revenue (%)		Securities firms generally
Net asset management/total revenue (%)		Securities firms generally
Net investment banking and derivatives/total revenue (%)		Securities firms generally
Cash flow		
EBITDA/interest expense	EBITDA with adjustments for significant non-cash items/interest expense	IDBs, advisory firms
EBITDA margin (%)	EBITDA with adjustments for significant non-cash items/revenue	IDBs, advisory firms
Market risk		
Average trading VaR – in US dollars or other currency units	Average period trading VaR considered as reported and adjusted to 99% confidence interval and one-day holding period. Data is assessed both including and excluding attributed diversification	Companies with material trading portfolios
Average VaR (ignoring diversification)/IRCC (%)	As above as a percentage of IRCC	Companies with material trading portfolios
Adjusted high VaR/IRCC (%)	High VaRs for the period in each class of securities adjusted to 99% confidence interval where necessary and one-day holding period, and added together as a percentage of IRCC	Companies with material trading portfolios
Stressed VaR/IRCC (%)	High VaRs added together linearly, ignoring diversification, adjusted where necessary to 99% and 10-day holding period, multiplied by five as a percentage of IRCC	Companies with material trading portfolios
Trading efficiency	Principal daily trading revenue [annual/252 days] or [quarterly/63 days]/average trading VaR [99%, one-day, US dollars] – measures how successfully an institution is able to turn risk into revenue; the higher the value, the more successful the institution	Companies with material trading portfolios
Number of loss days	Number of days in a period when a loss was recoded on the trading book	Companies with material trading portfolios

Source: Ind-Ra