

Criteria | Financial Institutions | General:

# Nonbank Financial Institutions Rating Methodology

December 9, 2014

*(Editor's Note: This article has been superseded by "Financial Institutions Rating Methodology," published Dec. 9, 2021, except in jurisdictions that require local registration.)*

1. This article presents S&P Global Ratings' methodology for assigning issuer credit ratings (ICRs) on nonbank financial institutions (NBFIs) globally. This article is related to "Principles Of Credit Ratings," published Feb. 16, 2011.
2. These criteria articulate the steps in developing the stand-alone credit profile (for an entity) or the unsupported group credit profile (for a group) to derive the ICR on an NBFI. They draw upon S&P Global Ratings' bank criteria (see "Banks: Rating Methodology And Assumptions," published Nov. 9, 2011) in many ways, in particular in placing heightened emphasis on economic risk and industry risk in setting the starting point, or anchor, in rating an institution. We add to or subtract notches from the anchor for entity-specific factors, such as business position; capital, leverage, and earnings; risk position; and funding and liquidity, to determine the unsupported group credit profile (GCP) or stand-alone credit profile (SACP) (see "Stand-Alone Credit Profiles: One Component Of A Rating," published Oct. 1, 2010). In certain cases, a low factor assessment, such as "weak," may cap the SACP or unsupported GCP. Lastly, the criteria apply our view of potential extraordinary support or intervention, including from a related government or entity's group, to arrive at the ICR and the GCP (which incorporates the impact of potential extraordinary support or intervention from a source external to the group, such as a government). In this article, we use SACP to refer to the SACP, as well as the unsupported GCP, which applies when a group is dominated by an NBFI. For guidance on how to apply these criteria, see "Guidance: Assumptions For Liquidity Stress Test Analysis Under 'Nonbank Financial Institutions Rating Methodology'," published March 22, 2018.

## SCOPE OF THE CRITERIA

3. These criteria apply to securities firms and financial companies, which we collectively refer to as NBFI.
4. Securities firms (or brokers) include regional and independent securities firms. NBFI brokers include retail- and wholesale-focused broker-dealers, which typically do not have banks in their organizational hierarchies, or, if they do, the bank is not a main factor in the business profile. They may benefit from prudential bank regulation, but lending is a minor portion of their business. Securities firms that benefit from prudential bank regulation and have substantial lending operations, or are global, large, and complex, are typically not in scope; they are typically rated under our bank criteria.
5. Most financial companies in scope are referred to as finance companies (fincos). We define fincos

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as financial institutions that are typically not registered as banks and that make loans to individuals or businesses. They are typically nondepository financial institutions and fund their investment and lending activities from the sale of securities. They primarily lend to consumers, businesses, and the commercial real estate sector. Fincos are neither special purpose vehicles (SPVs) nor investment funds. We rate two types of fincos: NBFi fincos and financial services finance companies (FSFC). We rate NBFi fincos under the NBFi criteria when we believe their greatest risks relate to asset quality, funding and liquidity, and tangible capital--some of the primary risks banks face. FSFC are entities that engage in financial activities but that depend largely on fee income and have limited balance sheet risk. They would typically be rated under our FSFC criteria (as outlined in "Corporate Methodology," published on Nov. 19, 2013, and in "Guidance: Corporate Methodology," published on July 1, 2019).

6. We also include in scope certain nonbank government-related entities. Although these criteria apply mostly to institutions that are not registered as banks or bank holding companies, they also apply to some institutions that are, but to which bank criteria are not applied. Typically, these institutions may have short track records as regulated entities, participate in activities that have historically been conducted by nonbanks, or depend significantly on nondeposit funding.
7. The criteria do not apply to banks or insurers to which we apply "Banks: Rating Methodology And Assumptions," published Nov. 9, 2011, or "Insurers Rating Methodology," published July 1, 2019.

## **SUMMARY OF THE CRITERIA**

8. The methodology consists of determining, in the following order:
9. **The anchor.** The methodology first sets the anchors for each NBFi sector in a given country. The anchor reflects the economic and industry risks that a sector faces. We use our bank anchors (derived according to our "Banking Industry Country Risk Assessment Methodology And Assumptions," published Nov. 9, 2011) as the starting point. For fincos, the preliminary anchor is three notches below the bank anchor in each country, and for securities firms, it is two notches below the bank anchor in each country. For fincos, this reflects higher industry risk resulting from their lack of central bank access, lower regulatory oversight, and higher competitive risk relative to banks (see "Industry And Idiosyncratic Risks For Finance Companies Are Generally Higher Relative To Banks," published Aug. 13, 2014). For securities firms, there is typically some form of regulatory oversight, so the anchor is only two notches below the bank anchor (see "Industry Risk For Securities Firms Is Generally Higher Than For Banks," published Aug. 13, 2014). In some cases, specific features of individual countries and sectors lead us to modify this standard two- or three-notch difference (i.e., either widen or narrow the gap) in determining the final anchors for fincos and securities firms in each country. If we don't make any modifications based on country- and sector-specific factors, the preliminary anchor and final anchor are the same.
10. **The SACP or unsupported GCP.** After setting the anchor, we then consider four factors and two adjustments to determine an SACP. The entity-specific factors we analyze are business position; capital, leverage, and earnings; risk position; and funding and liquidity. The two entity-specific adjustments are an anchor adjustment (for finance companies, if applicable, such as potentially for government-related entities, prudentially regulated or systemically important financial institutions, and monopolies) and a comparable ratings adjustment (i.e., comparative analysis with peers to determine whether a final one-notch adjustment applies). Unsupported GCPs are assessed using the same factors and adjustments as SACP members unless other group members are assessed using different criteria. The scope of the GCP analysis is the entire group. By contrast, for a group member, the scope of the SACP is the entity itself or, if it has subsidiaries, the

subgroup.

11. **The ICR.** Once we determine the SACP or unsupported GCP, we then incorporate our view of any relevant extraordinary government, group, or other external influence (which we collectively refer to as external influence) to arrive at the ICR or GCP. For some issuers, the ICR reflects the application of other criteria. For example, ICRs on government-related entities (GREs) are determined through the application of "Rating Government-Related Entities: Methodology And Assumptions," published March 25, 2015. Group influence is assessed according to "Group Rating Methodology," published July 1, 2019. Although unlikely, if we were to rate an NBFi higher than the sovereign in which the NBFi is domiciled, we would apply "Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions," published Nov. 19, 2013, to determine the maximum number of notches that the NBFi could be rated above the sovereign. In all cases, an ICR is 'CCC+' or lower, and an SACP or GCP is 'ccc+' or lower, if the conditions in "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings," published Oct. 1, 2012, are met.

**Table 1**

Nonbank Financial Institutions Ratings Framework Overview	
<b>Part I: Anchor</b>	A. Preliminary anchor (Two notches below the bank anchor [for securities firms] and three notches below the bank anchor [for finance companies] in each country) B. Sector- and country-specific anchor adjustments (When applicable, and in no case can the anchor exceed the bank anchor in the same country)  <b>A+B = Anchor</b>
<b>Part II: Entity-Specific Stand-Alone Credit Profile</b>	A. Entity-specific anchor adjustments (When applicable) B. Business position C. Capital, leverage, and earnings D. Risk position E. Funding and liquidity F. Comparable ratings adjustment  <b>Part I + Part II = SACP</b>
<b>Part III: External Influence And Sovereign Rating Limitations</b>	A. Group influence B. Government influence C. Guarantees or other external influence D. Rating above the sovereign (Maximum rating differentiation [if any] above the sovereign rating)  <b>Part I + Part II + Part III = ICR</b>

12. This paragraph has been deleted.

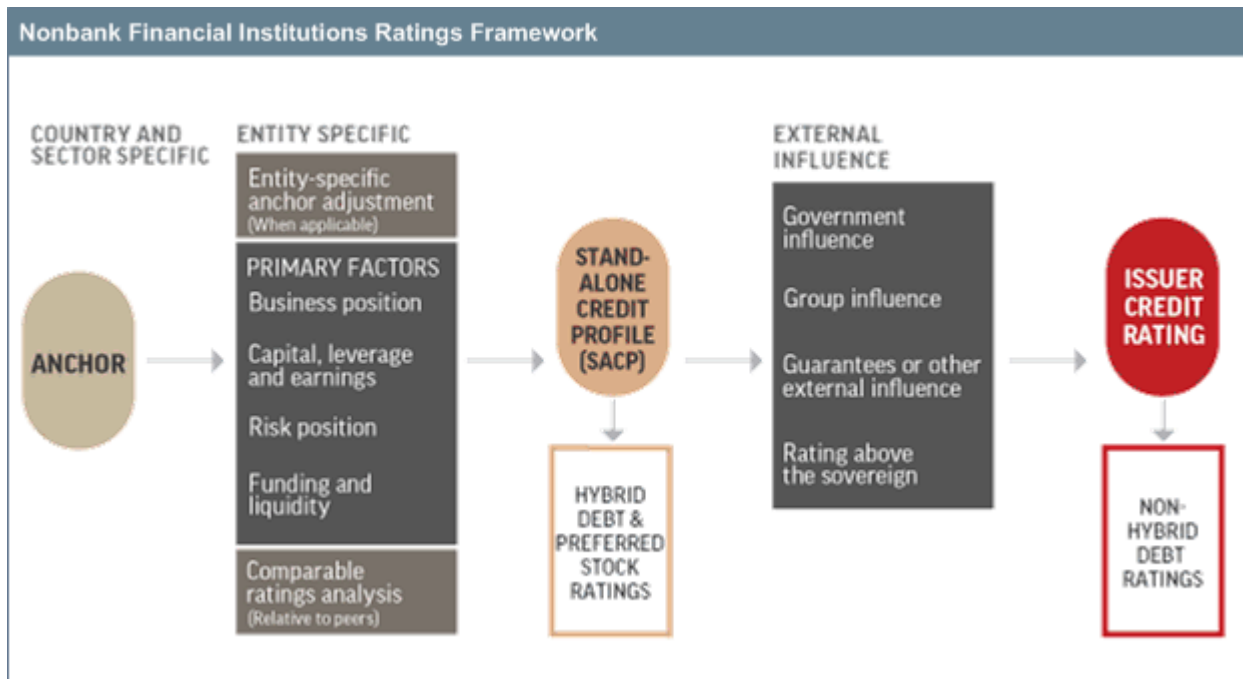
13. This paragraph has been deleted.

## METHODOLOGY

14. The methodology consists of determining, in the following order (see chart):

- The anchor. The anchor reflects the economic risk and industry risk a sector faces. Anchors are assigned on a sector and country basis (e.g., one anchor for all U.S. securities firms and one anchor for U.S. fincos).
- The SACP or unsupported GCP. The SACP or unsupported GCP is the anchor adjusted as per table 2, plus or minus the impacts of entity-specific factors and adjustments: anchor adjustments, business position; capital, leverage, and earnings; risk position; funding and liquidity; and comparable ratings adjustment.
- The ICR. To reflect our view of any relevant extraordinary government, group, or other external influence (which we collectively refer to as external influence), the criteria determine, in combination with the GCP and, typically, with the SACP, the ICR. For some issuers, the ICR reflects the application of other criteria. For example, ICRs on GREs are determined through the application of "Rating Government-Related Entities: Methodology And Assumptions." We assess the influence of group members through "Group Rating Methodology." Finally, although unlikely, if we rate an NBF1 higher than the sovereign in which the NBF1 is domiciled, we apply "Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions," published Nov. 19, 2013, to determine the number of notches that the NBF1 is rated above the sovereign. In all cases, an ICR is 'CCC+' or lower, or a GCP or an SACP is 'ccc+' or lower, if the conditions in "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings," published Oct. 1, 2012, are met.

15. We assess the anchor, business position, and comparable ratings adjustments, as well as any potential external influence and sovereign rating limitations, according to the same methodologies for both securities firms and fincos. We assess all aspects of capital, leverage, and earnings (except regulatory capital); risk position; and funding and liquidity according to different methodologies for the two NBF1 sectors to reflect their differing financial risks.



Note: In certain circumstances, hybrids are rated relative to the ICR. See "Hybrid Capital: Methodology And Assumptions," published July 1, 2019, for details on how we rate hybrids.

## I. Setting The Anchor

- Under the criteria, the first step in rating an NBFI is to set the anchor. We set the anchor for each sector in each country by first determining the bank anchor in that same country (see table 2 of "Banks: Rating Methodology And Assumptions," published Nov. 9, 2011). The preliminary anchor for securities firms is two notches below that bank anchor, and the preliminary anchor for fincos is three notches below that bank anchor. When an issuer is active in more than one country, we set the anchor to reflect the economic risks of those countries. That is, we calculate the economic risk score (which, with industry risk, determines the anchor) as a weighted average of the economic risk scores of each country (the weighting is typically done by exposure or revenue, see paragraphs 29-35 of "Banks: Rating Methodology And Assumptions," published Nov. 9, 2011). We then factor in any country- and sector-specific adjustments, if applicable, to determine the anchor. A final adjustment for some anchors is possible (see paragraphs 28-29). That adjustment is part of the SACP section because it is specific to an entity and not applicable across a sector or a country.

### A. Preliminary Anchor

- The bank anchor, which is the starting point for the NBFI anchors, reflects our economic risk and industry risk assessments, as determined by our BICRA methodology (see "Banking Industry Country Risk Assessment Methodology And Assumptions," published Nov. 9, 2011). These assessments combine to form the bank anchor specific to a given country (see table 2 in the bank criteria). The BICRA is an assessment of macro-level risks in each country. The analyses of economic resilience, economic imbalances, and credit risk in the economy comprise the economic risk assessment, and industry risk consists of institutional framework, competitive dynamics, and

systemwide funding.

18. The preliminary anchors for the NBFIs sectors are intended to reflect the typical incremental risks that NBFIs face relative to banks. As such, in all countries, we set the preliminary anchor for fincos three notches below the bank anchor, and the preliminary anchor for securities firms two notches below the bank anchor. (For example, if the bank anchor in a given country is 'bb+', the preliminary anchor for fincos in that same country is 'b+', and the preliminary anchor for securities firms in that same country is 'bb-'.) In our view, the incremental industry and economic risks for NBFIs relative to banks typically include the following:
- Both fincos and securities firms typically lack access to a central bank, which increases liquidity and funding risk relative to banks.
  - Both fincos and securities firms typically face strong competition from banks because of banks' lower cost of financing. In addition, fincos and securities firms have higher competitive risk, both among themselves and relative to banks, because of lower barriers to entry as well as more volatile or fragmented business conditions.
  - Finco usually lack the regulatory oversight that banks have, which heightens fincos' sensitivity to changes in investor confidence. Securities firms typically benefit from more regulatory oversight than fincos, but less than banks do.
  - Securities firms' economic risks may exceed those that banks face because they are exposed to equity market volatility, given their dependence on market liquidity to monetize assets they own.
19. These industry and economic risks are reflected in each sector's ratings performance (see "2012 Annual Global Financial Institutions Default And Rating Transition Study," published July 25, 2013). In our experience, although fincos may demonstrate financial strength, they default more frequently than banks. For securities firms, loss of funding during periods of market instability has led to notable defaults.

#### Deriving The Anchor

The preliminary anchors (of two and three notches below the bank anchor for securities firms and fincos, respectively) and the country- and sector-specific anchor adjustments were derived from the BICRA assessments in each country. In the case of both fincos and securities firms, the economic risk factors—economic resilience, economic imbalances, and credit risk in the economy—were unchanged. For securities firms, equity market volatility was added as an economic risk factor. For both sectors, the industry risk factors—institutional framework, competitive dynamics, and systemwide funding—were tailored for each sector through a rescoring of the BICRA factors in each country.

For the majority of countries, the results of reassessing the BICRAs leave the securities firms in each country two notches below the bank anchors and the fincos three notches below the bank anchors. We use this analysis to set the preliminary anchors. In some countries and sectors, two and three notches do not reflect our view of differences relative to the bank anchor. In those cases, we apply country- and sector-specific adjustments. The adjustments are summarized in paragraphs 20-24 and reflect results of the reassessment of the BICRA factors applied to each sector in each country.

## B. Country- And Sector-Specific Adjustments

20. We expect the anchor for each sector in each country to often be the same as the preliminary anchor. However, in some cases, country- or sector-specific adjustments result in the anchor

being higher or lower than the preliminary anchor. For a given sector, the anchor is higher than the preliminary anchor when the incremental risks between banks and the NBFIs are less than what is described in paragraph 18, and vice versa, but never higher than the bank anchor.

21. These country- and sector-specific adjustments occur typically in one of the two following situations.
22. The first situation in which we narrow the differential between the NBFIs anchor and the bank anchor is when an NBFIs sector's incremental risks relative to banks in the same country are considered lower than those identified in paragraph 18. In such a circumstance, we reduce the differential by one or two notches for securities firms and by one to three notches for fincos. (Take, for example, a bank anchor of 'bbb'. The corresponding finco sector preliminary anchor in the same country is three notches lower, at 'bb'. Based on our analysis here, we reduce that three-notch gap so that the finco preliminary anchor is 'bb+', 'bbb-', or 'bbb'.) Situations where we reduce the differential include:
  - The NBFIs sector benefits from a stronger institutional framework (government oversight). In some countries, fincos are regulated or have other supportive institutional framework elements.
  - Funding is stronger for the NBFIs sector (e.g., the sector has access to central bank funding). In some countries, fincos have direct access to central bank funding, or indirect access to central bank funding, for example through government-sponsored development banks.
  - Regulations preserve competitive position (and, hence, reduce competitive risk) for fincos or securities firms. In some countries, government regulators restrict the number of licenses they grant to NBFIs to enter into certain businesses.
23. Conversely, the differential is widened by one notch if the NBFIs faces additional funding, economic, or competitive risks, or if it has a weaker institutional framework than assumed in the preliminary anchor. For example, for securities firms, the country-specific anchor is one notch below the preliminary anchor when no regulatory oversight exists, or if economic and funding risks are heightened by less liquid or more volatile capital markets.
24. The second situation in which we narrow the differential is when the bank anchor is low and already reflects some of the incremental risks we typically see in the NBFIs sector. The differential between the bank and NBFIs anchors decreases in countries where banks and NBFIs face similar levels of risk. Specifically, in countries where the bank anchor is between 'b-' and 'bb+', we reduce or eliminate the differential.

## **II. Entity-Specific Stand-Alone Credit Profile**

25. After setting the anchor, we start our entity-specific analysis by, in some cases, adjusting the anchor. We expect this entity-specific anchor adjustment to apply to few fincos. Then we consider the primary SACP factors: business position; capital, leverage, and earnings; risk position; and funding and liquidity. Finally, we factor in a comparable ratings adjustment, if applicable. These factors determine the SACP or unsupported GCP, relative to the anchor. They each, incrementally, may raise the SACP or unsupported GCP by up to two notches or lower the SACP or unsupported GCP by as many as five notches from the anchor and, in some cases, may cap the rating, SACP, or unsupported GCP (see table 2).
26. Business position assesses the strength of a firm's business operations relative to peers. Capital, leverage, and earnings (CLE) assesses a firm's ability to absorb losses, which provides protection to senior creditors while the firm remains a going concern. Risk position is a relative assessment

that refines our view of a firm's actual and specific risks beyond the conclusion arising from the standard assumptions in the CLE analysis. Funding and liquidity assesses a firm's capacity to support business performance through effective funding, while managing liquidity requirements both on an ongoing basis and in stress conditions. Finally, the comparable ratings analysis reflects the occasional need to fine-tune SACP outcomes, even after incorporating each of the other factors.

27. These criteria have different methodologies for assessing all aspects of CLE (except regulatory capital), risk position, and funding and liquidity for fincos and securities firms. For the other parts of the entity-specific analysis--the anchor adjustment, business position, and comparable ratings adjustment--we use the same methodology for both sectors.

Table 2

**Impact Of Entity-Specific Factors On The SACP Or GCP**

Factor and assessment	Impact on SACP or GCP up or down from the anchor* (number of notches)
<b>Business position</b>	
Very strong	+2
Strong	+1
Adequate	0
Moderate	-1
Weak	-2
Very weak	-3§
<b>Capital, leverage, and earnings</b>	
	When the bank anchor† of the country in which the NBFIs is located is 'bbb-' or higher, capital, leverage, and earnings affects the SACP or GCP as follows:
Very strong	+2
Strong	+1
Adequate	0
Moderate	-1
Weak	-2 or -3
Very weak	-3 to -5
	When the bank anchor† of the country in which the NBFIs is located is 'bb-', 'bb', or 'bb+', capital, leverage, and earnings affects the SACP or GCP as follows:
Very strong	+2
Strong	+1
Adequate	0
Moderate	0
Weak	-1
Very weak	-2 or -3
	When the bank anchor† of the country in which the NBFIs is located is 'b-', 'b', or 'b+', capital, leverage, and earnings affects the SACP or GCP as follows:
Very strong	+2
Strong	+2
Adequate	+1



Table 2

**Impact Of Entity-Specific Factors On The SACP Or GCP (cont.)**

Factor and assessment	Impact on SACP or GCP up or down from the anchor* (number of notches)
Moderate	0
Weak	0
Very weak	-1 or -2
<b>Risk position</b>	
Very strong	+2
Strong	+1
Adequate	0
Moderate	-1
Weak	-2
Very weak	-3
Funding and liquidity	The impact of funding and liquidity on the SACP or GCP results from the combination of our assessments of funding and liquidity (see table 21 for fincos and table 24 for securities firms).

Note: An entity is assigned a SACP, or a group is assigned a GCP, of 'ccc+' or lower if it meets the conditions in "Criteria For Assigning 'CCC+', 'CCC-', 'CCC-', And 'CC' Ratings," published Oct. 1, 2012. \*Anchor including the entity-specific anchor adjustment. †The capital, leverage, and earnings assessments in this table refer to the bank anchor for each country. Risk-adjusted capital is calibrated for banks given bank anchors and bank loss expectations. We adjust, in the risk position section, for the difference in loss expectations and asset quality between banks and NBFIs.

**A. Entity-Specific Anchor Adjustment**

- 28. An entity-specific anchor adjustment can result in an entity's anchor being higher or lower than the anchor for the rest of the sector. We may make an adjustment here if we haven't already made country- or sector-specific anchor adjustments for that entity. As with the country- and sector-specific adjustments, we do not expect any entity-specific anchor adjustment to result in an NBFIs anchor being higher than the bank anchor. We expect the entity-specific anchor adjustment typically to apply to GREs that have a "very high," "extremely high," or "almost certain" likelihood of receiving extraordinary government support, as described in table 1 of the GRE criteria ("Rating Government-Related Entities: Methodology And Assumptions"). Even if not prudentially regulated as banks, these GREs benefit, on an ongoing basis, from more favorable funding given their relationship to the government, from regulatory oversight, or from lower competitive risk, if they are regulated or de facto monopoly (or oligopoly) industry participants.
- 29. For certain non-GRE fincos, we also apply an entity-specific anchor adjustment, as described in paragraph 28, to reflect these entities' markedly different characteristics from most other fincos in the same country. Typically, this applies to fincos benefiting from the presence of a nonoperating holding company regulated by a banking supervisor or a quasi-monopoly status granted by or influenced by a regulator.

**B. Business Position**

- 30. Business position is the first SACP factor and assesses the strength of a firm's business operations relative to peers. (For details on how we select peer groupings, see the "Comparable

Ratings Adjustment" section.) The assessment is based on three subfactors (see table 3): business stability (see table 6), business diversity (see table 7), and management and governance (see tables 8-10). The analysis is both qualitative and quantitative.

Table 3

**Business Position Subfactors**

Subfactors	Explanations	Subfactor descriptors	Indicators
Business stability (paragraphs 36-47)	The stability or fragility of a firm's business franchise and operating performance (through business cycles)	Very strong, strong, adequate, moderate, weak, or very weak	Business mix, revenue stability, market position, and customer base (confidence sensitivity of clients and other outside commercial parties). In situations where profitability has a material negative impact on market position, this may limit the assessment.
Business diversity (paragraphs 48-59)	The concentration or diversification of business activities	Strong, adequate, moderate, or weak	Concentration of revenue contribution from different business lines (and products within those lines), geographies, and customers
Management and governance (paragraphs 60-61)	The quality of management, strategy, and corporate governance	Strong, satisfactory, fair, or weak	Strategic positioning, operational performance, organizational effectiveness, risk and financial management, and governance

- 31. We assess overall business position on a six-category scale, from "very strong" to "very weak" (see table 4). We first combine business stability and business diversity according to table 5. Management and governance (see table 10), if "fair" or "weak," may cap or lower the overall assessment derived from table 5 but does not raise the overall assessment.
- 32. The business position assessments reflect assumptions made in the anchor. For example, a firm may not be a GRE, or systemically important, and yet may benefit from economic or industry strength not recognized as an entity-specific anchor adjustment. This would demonstrate strength relative to peers in light of the anchor assumptions and typically would improve the business position assessment by one level (for example, from "moderate" to "adequate").

Table 4

**Business Position Assessment Descriptions**

Descriptor	What it means
Very strong	An NBF's business position is much stronger than that of other NBFs with a similar anchor, and its business operations make it better able to withstand adverse operating conditions than the anchor indicates.
Strong	An NBF's business operations make it somewhat less vulnerable to adverse operating conditions than the anchor indicates.
Adequate	An NBF's business risk is consistent with the anchor and similar to peers' with the same anchor.
Moderate	An NBF's business operations make it more vulnerable to adverse operating conditions than indicated by the anchor.
Weak	An NBF's business operations make it significantly more vulnerable to adverse operating conditions than indicated by the anchor.
Very weak	The anchor is not representative of the extent of an NBF's business risk or vulnerability to adverse operating conditions.

- 33. An "adequate" business position means that the anchor (after giving effect to any entity-specific adjustment) appropriately captures the risk of a firm's business activities. Assessments of "very strong" and "strong" mean that an NBF's business activities are less risky than average for firms

with a similar anchor. A firm is unlikely to be assessed as "very strong" or "strong" if its business and revenue are contracting while competitors are growing. "Moderate," "weak," and "very weak" mean that a firm's business activities are riskier or less stable than average and represent additional risk beyond what is reflected in the anchor.

34. The strength of a firm's business position reflects the relative stability of its franchise and its resilience to adverse operating conditions. This is why, in table 5, the business stability assessment typically carries the most weight unless offset by acute weakness or, rarely, strength in business diversity. Collectively, the indicators and subfactors may add to or mitigate the risks assumed in the anchor. For example, high volatility of revenue, low pricing power, and weak market position--absent any regulatory influence over revenue, price, or competition--would all weigh negatively on the business position. If they are relevant and available, quantitative metrics are used either as the basis of the subfactor assessments (i.e., business diversity considers the revenue contribution of business lines) or to identify firms with outsize risks. In particular, business stability is typically capped at "moderate" if the majority of revenue is from businesses that are highly sensitive to changes in investor confidence or market volatility.
35. If two outcomes are possible when combining business diversity with business stability (in table 5), management and governance, when assessed as "fair" or "weak," typically limits the outcome to the lower of the two. Additionally, management and governance may cap business position as follows:
- A "fair" management and governance assessment limits business position to "strong." "Strong" would typically only be possible when management weaknesses are unlikely to impair business stability.
  - A "weak" management and governance assessment typically limits business position to "moderate," and to "weak" or "very weak" when business stability may be impaired by management weaknesses.

Table 5

**Determining The Business Position Assessment\***

--Business diversity--	--Business stability--					
	Very strong	Strong	Adequate	Moderate	Weak	Very weak
<b>Strong</b>	Very strong or strong	Strong	Strong or adequate	Adequate or moderate	Moderate or weak	Weak or very weak
<b>Adequate</b>	Strong or adequate	Strong or adequate	Adequate	Moderate	Weak	Very weak
<b>Moderate</b>	Strong or adequate	Adequate or moderate	Adequate or moderate	Moderate	Weak	Very weak
<b>Weak</b>	Adequate or moderate	Adequate or moderate	Moderate or weak	Moderate or weak	Weak	Very weak

\*The business position assessment is the outcome of this table, as modified by paragraph 35.

**1) Business stability**

36. Business stability, the first business position subfactor, assesses the predictability of continuing business volumes in the face of potential economic and market fluctuations. A firm's business stability would typically not be "strong" or "very strong" if its core operating performance was expected to be weaker or more volatile than those of peers. The anchor recognizes that the NBF

sector's business stability is inherently more volatile than that of banks. If a firm experiences business volatility that is consistent with expectations reflected in the anchor and after giving effect to any entity-specific anchor adjustment, that firm likely would have an "adequate" business stability assessment. The assessment is typically "moderate" if the entity has higher-risk businesses, as demonstrated by materially less stable revenue and profitability (i.e., positive net income). The assessment is "weak" if the entity is not expected to achieve profitability, or "very weak" if the entity is projected to consistently fail to achieve profitability. However, low profitability, if caused by risk mitigation efforts instead of lack of market position, does not limit the assessment to "weak" or "very weak" unless anticipated to be prolonged.

37. The indicators that inform our view of business stability are business mix, revenue stability, market position, and customer base (see table 6). Business mix considers the risk of the mix of business lines as well as the risk of business lines themselves (and products in those lines), particularly exposure to confidence-sensitive business. Revenue stability considers a firm's revenue dynamics and historical revenue stability. Market position considers the size and stability of market share, as well as profitability. Customer base reflects a firm's exposure to customer confidence sensitivity (i.e., the stability and reliability of customer relationships). Profitability may limit the business stability assessment to "moderate" or lower, as per the previous paragraph.
38. Importantly, our business stability expectations for each business stability assessment take into account industry risk-driven adjustments that lower the anchor below the bank anchor in each country. For example, a firm's business stability could be "adequate" despite some business instability because the anchor already reflects, among other factors, heightened competitive risk. In another example, business stability may be "strong" or "very strong" when, although an entity-specific anchor adjustment was not warranted, the firm's observed and expected business stability are comparable to an average bank operating in the same country.

Table 6

### Business Stability Assessment

Assessment	Guidance
Very strong	The firm's business mix is more stable and lower risk than peers, with no material high-risk business lines; a very stable or strong market position and sticky customer relationships dominate the customer base; or very high levels of contractually recurring revenue support very strong revenue stability and demonstrate significant additional strengths relative to peers and what is captured in the anchor.
Strong	The firm's business mix is more stable and lower risk than peers. In addition, it has a stable or strong market position, and stable customer relationships represent the majority of revenue. However, the absence of a strong market position and a stable customer base can be offset by having high levels of contractually recurring revenue, which then support strong revenue stability. Strong revenue stability leads to a "strong" business stability assessment if it results in greater business stability relative to peers'.
Adequate	The firm's business stability is average relative to peers, with any strength or weakness offsetting each other, and its market position and the nature of its businesses, revenue, products, and customer relationships do not represent incremental risk above what is captured in the anchor. We expect the firm to demonstrate revenue stability on par with peers.
Moderate	A weaker market position, higher risk, or more confidence-sensitive mix of business is only partially offset by any strengths, and this leads us to expect weaker revenue stability relative to peers, thus demonstrating modest incremental risk above what is captured in the anchor.
Weak	The risk or unstable nature of the firm's mix of business, some aspect of the firm's market position, customer confidence sensitivity, or expected revenue stability are materially weaker than average, or represent substantial risk beyond risks captured in the anchor.

Table 6

**Business Stability Assessment (cont.)**

Assessment	Guidance
Very weak	The firm has substantial exposure to high-risk, confidence-sensitive, or unstable businesses, or a "very weak" market position and revenue stability compared with those of peers. Business risk and confidence sensitivity, poor market position or poor revenue stability may individually, or together, result in a very weak assessment.

Note: References to the anchor in the SACP or GCP include any entity-specific adjustment described in the "Entity-Specific Anchor Adjustment" section.

**i) Business mix**

- 39. Business mix supports business stability when:
  - The mix of business is lower risk than peers;
  - Exposure to highly confidence-sensitive businesses is lower than peers; or
  - The majority of revenue is less sensitive to market perceptions of creditworthiness.
- 40. Business mix detracts from business stability if any of the following apply (as the number of observed indicators increases, business stability weakens):
  - The mix of business is higher risk than peers.
  - Exposure to highly confidence-sensitive businesses is higher than peers, which may be observed in unfavorable contractual terms, such as financial covenants, credit triggers, and collateral requirements, that are more demanding than for peers with a similar anchor carrying out the same types of business activities.
  - The majority of revenue is more sensitive to market perceptions of creditworthiness.
  - Conceivable changes to regulations or laws could significantly impair the company's businesses (such as regulatory changes that may reduce the company's ability to originate or collect loans).

**ii) Revenue stability**

- 41. Revenue stability supports business stability to the degree that revenue is less susceptible to an economic downturn or period of market turbulence. An example is when recurring fee or interest income or revenue from long-standing customer relationships represents a higher proportion of revenues than it does for peers.
- 42. Revenue stability detracts from business stability when one or more of the following contribute to revenue being more susceptible than peers' to volatility during adverse conditions:
  - Relative to peers, a larger portion of revenue comes from unstable or highly correlated businesses, like trading income or other market-sensitive income.
  - Recurring fee or interest income or revenue from long-standing customer relationships represents a smaller proportion of revenues than it does for peers.
  - Revenues have been less stable than for peers.

### iii) Market position

43. Market position supports business stability when a firm has an established track record of profitability and presence in its core business lines, and at least one of the following applies:
- The firm's market share is higher than average relative to peers, is at least as stable as peers, and is not more dependent than industry peers on lowering prices to retain customers.
  - We expect the firm's market share to grow or to be more sustainable than that of peers because at least one of the following applies: government action or regulation restricts competition more than it does for peers; the firm has a significant market share across broad business lines; the firm operates in highly defensible and less volatile niche businesses, particularly those with high barriers to entry (for example, if the firm has expertise and leadership in a climate change or climate transition niche); or the firm has demonstrated competitive strength (without taking on higher-than-average product risk).
44. Market position detracts from business stability when it is lower or less stable than that of peers that are in the same NBFIs sector and have a similar anchor. Profitability that is weak or more volatile than peers' typically indicates a weaker or less stable market position.

### iv) Customer base

45. Customer base supports business stability when at least one of the following applies:
- The majority of revenues are from businesses where the customer base is considered demonstrably "sticky," meaning the firm has long-standing customer relationships or is less sensitive to changes in customer behavior (either because they are contractually recurring or strategic to both parties);
  - The majority of clients are wholesale but have demonstrated loyalty through past periods of economic turbulence; or
  - Customers, sponsors, syndicate partners, and counterparties have tied their business platforms to the firm.
46. Customer base detracts from business stability when, relative to peers, revenue is more sensitive to customer confidence and we have less confidence that customers or business partners will stay with the firm during a period of financial stress because:
- Customers, sponsors, syndicate partners, and counterparties can walk away with little consequence to them (for example, if the firm has issues regarding its conduct with retail customers, such as failure to comply with regulations on the sale of financial products or fraudulent conduct of salespeople, or if it has reputational issues due to events such as money laundering, tax evasion, or cyber security breaches); or
  - The relationship between the firm and its customers is viewed to be weaker than peers.
47. This relationship can be weaker than peers because:
- There are few or no direct relationships between the end customer and the firm. The firm relies on third parties to supply business; or
  - The relationship between customers and the firm is commodity-like and based on a series of one-off transactions, and the customers' business typically goes to the lowest-cost provider, regardless of customer relationship.

## 2) Business diversity

48. Business diversity is the second subfactor of the business position assessment (see table 7). We assess it by analyzing three indicators: business line revenue diversification, geographic diversification, and customer revenue concentrations. Although not a subfactor of business stability, business diversity strengthens or weakens a firm's business stability prospects.

Table 7

### Business Diversity Assessment

Assessment	Guidance
Strong	The firm has significantly more extensive and successful business line or geographic diversification than average for peers, which we expect will result in more stable revenue through the cycle.
Adequate	The firm's business is not materially more or less concentrated than average for peers and does not add or mitigate risks assumed in the anchor.
Moderate	The firm's business is modestly more concentrated than average for peers, and the concentration represents modest incremental risk above what is captured in the anchor, but it is not a key credit weakness.
Weak	The firm's business is concentrated in a volatile business segment that represents a substantial additional risk, relative to risks captured in the anchor, which is a material credit weakness.

49. **Business line revenue diversification.** In this area, we focus on revenue and assess the exposure a firm has to a shift in market appetite away from a key revenue contributor. For firms whose revenue would significantly diminish in the wake of a significant slowdown or cessation of a business line or product within a business line, business diversity is "moderate" or "weak."
50. **Geographic diversification.** Here we assess a firm's exposure to a given geographic area. Typically, this would be measured as the portion of revenue derived in one country, but could also be viewed as one region within a country or across countries, depending on the size and scale of the countries. Business diversity is "moderate" or "weak" for a firm whose revenue would significantly diminish in the wake of a significant slowdown or cessation of business in a country or region.
51. **Customer revenue concentration.** In this area, we assess a firm's exposure to a potential loss of one customer or a small number of customers. It is assessed as negative if we expect that revenue would fall significantly in the wake of such a loss, as we typically would expect if either a single customer or a small group of customers materially contributes to revenue. For a securities firm, the assessment is based on counterparty concentrations. Customer revenue diversification does not necessarily lead to "strong" business diversity, unless the firm's revenue is highly resilient to customer flight.
52. We expect to assess few firms as having "strong" business diversity. Typically, concentrations are measured by the contributions of different business lines and geographies to overall revenue, compared with firms in the same sector and with similar industry risk. Collectively, the three indicators address a firm's ability to withstand a change in industry structure, a change in local and regional economies, or loss of one or more key customers. Unless one indicator dominates, the assessment is as follows:
- If all indicators are negative, the subfactor is typically "weak."
  - If any one indicator is so negative that it could impair business stability, the subfactor is

"weak."

- If all indicators are positive and business diversity is "strong," the subfactor is "strong."
- If one indicator is negative but the combination of indicators is representative of the industry as assessed in the anchor, the subfactor is "adequate."
- If one or more, but not all, indicators are viewed as negative factors in the business diversity assessment and the combination of indicators is weaker than represented for the sector in the anchor, then the assessment is typically "moderate."

53. Here are some examples of how we assess business diversity.

54. Positive expectations for diversification support a business diversity subfactor assessment of "strong." These expectations support a "strong" assessment only when past observations demonstrate earnings strength relative to the industry during a domestic economic downturn. If the expectation is positive, but we have no track record against which to measure those expectations, we assess business diversity as "adequate." Businesses often grow and diversify revenue sources when the economy is growing. However, for most firms, that diversification disappears when the economy shrinks, and, thus, creditworthiness deteriorates. We focus on a firm's track record during a recent economic downturn, if available, to dampen a potentially procyclical assessment of business diversity in which multiple channels of business shrink when market conditions turn.
55. Concentrated business lines, or concentration of business in few geographic locations or to relatively few customers, still support an "adequate" (but not "strong") assessment when the concentration is not expected to have a meaningful impact on the overall business position. Small or niche firms may demonstrate strong competitive position and revenue stability through economic and business cycles. In those cases, the subfactor is assessed as "adequate."
56. When competitive position is not easily defended and we expect revenue stability may weaken (for example, due to lending or other activities that may be socially sensitive and exposed to claims from retail clients and additional investigations from regulators), a more limited product range or geographic breadth, particularly for a firm with significant regional, product, or customer concentrations, would leave the firm more exposed to a local economic downturn relative to peers and support a subfactor assessment of "moderate" or "weak."
57. A firm may have revenue that is concentrated in an attractive region, product, or customer segment and still receive a business diversity assessment of "adequate" or higher, if the firm also has stable revenue. If revenue is concentrated and volatile, the assessment can't be higher than "moderate." Geographic diversification, if present when assessed in the context of the size of the local economy and the size of the NBFi industry and markets, supports an assessment of "adequate" or higher. When concentrated, it may still support an assessment of "adequate" or higher when combined with projected stable or increasing revenue. When we anticipate revenue to be unstable or decreasing, the assessment can't be higher than "moderate."
58. Increasing business line revenue diversification by entering new products and countries where a firm has limited expertise is not a positive. It is also not a positive when the firm is lacking critical mass to be a real competitor to the incumbent market leaders. This limits the subfactor assessment to "moderate" when the new products or markets are riskier than the traditional core business.
59. Acquisitions can increase concentration risk if the acquired assets are similar to those in a firm's existing book, and particularly when the firm does not increase risk-adjusted capital in line with assets and risks. Acquisitions support an assessment of "adequate" or higher when they are neutral or positive to earnings and they improve business line, revenue, geographic, or customer



diversification.

### 3) Management and governance

60. Management and governance--the third business position subfactor--addresses how management's strategic competence, organizational effectiveness, risk management, and governance practices shape an issuer's competitiveness in the marketplace, the strength of its financial risk management, and the robustness of its governance. Stronger management of important strategic and financial risks (which may include emerging risks surrounding environmental, social, and governance factors as well as contingency planning around cyber risk) supports creditworthiness.
61. We assess management and governance by applying, with two modifications, our methodology for corporate ratings, "Methodology: Management And Governance Credit Factors For Corporate Entities," published Nov. 13, 2012 (the "M&G criteria") (see tables 8-9). The assessments for management and governance are "strong," "satisfactory," "fair," and "weak" (see table 10 and paragraph 31).

Table 8

#### Assessment Of Management Indicators

	Positive	Neutral	Negative
<b>Indicators used to evaluate strategic positioning</b>			
1. Strategic planning process (see M&G criteria paragraphs 16-17)	There is evidence of strategic plans that contain specific financial and operational goals with clear measures of achievement.	Evidence of strategic plans exists, but aspects lack depth or specific financial/operational goals; achievement measures are unclear.	There is very limited evidence that strategic plans exist, or plans are superficial.
2. Consistency of strategy with organizational capabilities and marketplace conditions (see M&G criteria paragraphs 18-20)	Strategy is nearly always consistent with enterprise's capabilities, taking into account marketplace conditions; has a track record of market leadership and effective innovation.	Strategy is generally consistent with enterprise's capabilities, taking into account marketplace conditions.	Strategy is inconsistent with enterprise's capabilities or marketplace conditions; abrupt or frequent changes in strategy, acquisitions, divestitures, or restructurings occur.
3. Ability to track, adjust, and control execution of strategy (see M&G criteria paragraphs 21-22)	Management has been able to convert nearly all strategic decisions into constructive action; has a track record of achieving financial/operational goals, and is successful relative to peers.	Management has been able to convert most strategic decisions into constructive action; has a track record of achieving most financial/operational goals.	Management is often unable to convert strategic decisions into constructive action; often fails to achieve its financial/operational goals.
<b>Indicators used to evaluate risk management/financial management</b>			
4. Comprehensiveness of enterprisewide risk management standards and tolerances (see M&G criteria paragraphs 27-28)	Management has successfully instituted comprehensive policies that effectively identify, monitor, select, and mitigate key risks and has articulated tolerances to key stakeholders.	Management has a basic set of standards and tolerances in place, but may not have fully developed risk management capabilities.	Management has no or few defined standards and tolerances and little risk management capability.

Table 8

**Assessment Of Management Indicators (cont.)**

	<b>Positive</b>	<b>Neutral</b>	<b>Negative</b>
5. Financial policy – standards	Management has set rigorous but reasonable standards for financial management.	Management has set standards for financial performance that are achievable and similar to industry norms.	Management lacks wherewithal, discipline, or commitment to achieve set financial standards, or has low standards.
6. Financial policy – tolerance	Management meets or exceeds rigorous but reasonable standards for financial management.	Management meets standards for financial performance that are achievable and similar to industry norms.	Management lacks wherewithal, discipline, or commitment to meet financial standards.
<b>Indicator used to evaluate operational performance</b>			
7. Standards for operational performance (see M&G criteria paragraphs 33-34)	Management has set rigorous and ambitious, but reasonable, standards for operational performance.	Management has set standards for operational performance that are achievable and similar to industry norms.	Management lacks wherewithal, discipline, or commitment to achieve set standards, or has low standards.
<b>Indicators used to evaluate organizational effectiveness</b>			
8. Management’s operational effectiveness (see M&G criteria paragraphs 36-37)	Management has a demonstrated history of not incurring unexpected declines in earnings or cash flow emerging from operational risks.	Emergence of unexpected operational risks occasionally affects earnings or cash flow.	Emergence of unexpected operational risks regularly affects earnings or cash flow.
9. Management’s expertise and experience (see M&G criteria paragraphs 38-39)	Management has considerable expertise, experience, and a track record of success in operating all of its major lines of business.	Management has sufficient but unexceptional expertise and experience in operating its major lines of business.	Management lacks the expertise and experience to fully understand and control many of its businesses. The enterprise often deviates significantly from its plans.
10. Management’s depth and breadth (see M&G criteria paragraphs 40-41)	Management has good depth and breadth across its major lines of business, and it can withstand loss of key personnel without significant disruption to operations or cash flows in each of its significant business units.	Management depth or breadth is limited in some areas. The loss of key personnel would be expected to only temporarily affect the enterprise’s operations or cash flows.	The enterprise relies on one or a small number of managers. The loss of key personnel would seriously affect the enterprise’s operations.

Note: M&G criteria is "Methodology: Management And Governance Credit Factors For Corporate Entities."

Table 9

**Assessment Of Governance Indicators**

	<b>Neutral</b>	<b>Negative</b>
1. Board effectiveness (see M&G criteria paragraph 44)	The board maintains sufficient independence from management to provide effective oversight of it. The board retains control as the final decision-making authority with respect to key enterprise risks, compensation, and/or conflicts of interest.	The board manifests a lack of independence from management and provides insufficient oversight and scrutiny of key enterprise risks, compensation, and/or it tolerates unmanaged conflicts of interest.

Table 9

**Assessment Of Governance Indicators (cont.)**

	<b>Neutral</b>	<b>Negative</b>
2. Entrepreneurial or controlling ownership (see M&G criteria paragraph 45)	Management and the board of directors have professional, independent members who are capably engaged in risk oversight on behalf of all stakeholders, including minority interests. The influence of controlling shareholders is offset by risk-aware professional management and a board that effectively serves the interests of all stakeholders.	Controlling ownership negatively influences corporate decision-making to promote the interests of the controlling owners above those of other stakeholders (for example, through loans to owners or owner-related entities, or through owner-directed transactions with other owned entities).
3. Management culture (see M&G criteria paragraph 46)	Management is responsive to all stakeholders' interests, appropriately balances those interests, and acknowledges that the board of directors is the ultimate decision-making authority.	Management's own interests (or those of a narrow group of stakeholders) are its primary concern, where dissent in the executive suite is generally not tolerated, or where management proves incapable of managing conflicts of interest arising between different stakeholder groups. Excessive management turnover can be an indicator of a governance deficiency in management culture. Alternatively, management dominates the board of directors, as demonstrated by the control exercised by the chair or CEO, or as evidenced by compensation and incentive programs that promote outsize risk-taking.
4. Regulatory, tax, or legal infractions (see M&G criteria paragraph 47)	The enterprise generally remains free of regulatory, tax, or legal infractions and has stable relationship with regulatory authorities.	The enterprise has a history of regulatory, tax, or legal infractions beyond an isolated episode or outside industry norms, representing significant risk to the enterprise.
5. Communication of messages (see M&G criteria paragraph 48)	The enterprise generally communicates consistent messages to all constituencies.	The enterprise communicates conflicting information to different stakeholders on significant issues.
6. Internal controls (see M&G criteria paragraphs 49-50)	The enterprise's internal control environment is not viewed as deficient.	The enterprise's internal control environment is viewed as deficient based on available evidence, such as restatements or delays in filings.
7. Financial reporting and transparency (see M&G criteria paragraphs 51-52)	Accounting choices are usually reflective of the economics of the business.	The enterprise's financial statements obfuscate the true intent or the economic drivers of key transactions, or the financial statements are insufficient to allow typical users of the financial statements to understand the intent and the economic drivers.

Note: M&G criteria is "Methodology: Management And Governance Credit Factors For Corporate Entities."

Table 10

**Assessment Of Management And Governance**

<b>Assessment</b>	<b>Related indicators</b>
1. Strong	At least six of the 10 strategic positioning, risk management, operational performance, and organizational effectiveness indicators are positive, and none are negative, and no negative scores for governance.
2. Satisfactory	Four or five of the 10 strategic positioning, risk management, operational performance, and organizational effectiveness indicators are positive, and none are negative, and no negative scores for governance.
3. Fair	Combinations not covered by other descriptors--or--any negative score for a governance indicator.

Table 10

**Assessment Of Management And Governance (cont.)**

Assessment	Related indicators
4. Weak	Six or more of the 10 strategic positioning, risk management, operational performance, and organizational effectiveness indicators are negative, or key aspects of management are potentially harmful to the company’s risk profile, or any governance deficiencies are considered severe.

**C. Capital, Leverage, And Earnings**

- 62. Capital, leverage, and earnings (CLE), the second SACP or GCP factor under the criteria, assesses a firm’s ability to absorb losses, which provides protection to senior creditors while the firm remains a going concern. In addition to any regulatory capital assessments, the focus of our CLE analysis for NBFIs addresses the sufficiency of risk-absorbing capital, the presence of high absolute leverage (debt to equity or equity to assets), the quality of capital, and the ability of earnings to offset losses. We assess regulatory capital, where it applies, for both securities firms and fincos according to the same methodology. For the other aspects of CLE, our methodologies differ for the two sectors.

**Regulatory capital**

- 63. We assess risk pertaining to regulatory requirements for capital only for NBFIs that operate under prudential regulatory capital standards (see table 11). Potentially the outcome of the regulatory capital assessment is an SACP or GCP below 'b-', consistent with "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings," published Oct. 1, 2012, which we apply when considering an SACP or GCP below 'b-'. Typically, fincos are not subject to regulatory capital standards, and securities firms are subject to regulation of activities at the operating company level. Both securities firms and fincos may be subject to bank regulatory capital standards if they are part of a group that includes a bank holding company. If an NBFI is not "at risk," "subject to regulatory forbearance," or "insolvent" per table 11, CLE is assessed solely as described in the subparts applicable to fincos and securities firms.

Table 11

**Regulatory Capital Assessment**

Assessment	What it means/impact
At risk	An NBFI’s SACP or GCP is capped at 'bb+' when it meets regulatory capital requirements for its license--but by a narrow margin, usually less than 100 basis points. At this level, the criteria regard an NBFI as “at risk” of breaching its regulatory requirements in case of plausible adverse developments since its regulatory capital ratios are close to breaching levels that would trigger a regulatory intervention. When the descriptor is “at risk,” CLE is “weak,” at best.
Subject to regulatory forbearance	An NBFI’s SACP or GCP is capped at 'ccc+' when the regulator allows the NBFI to continue operating even though it is in breach of regulatory requirements for its license (i.e., is subject to regulatory forbearance). This might occur if the regulator gives it a temporary waiver or a ruling that calculates regulatory capital requirements more generously than usual. The category also includes NBFIs that would be in breach of regulatory minimum requirements if they had reported losses in accordance with accepted accounting principles but did not report such losses. When the descriptor is “subject to regulatory forbearance,” CLE is “very weak.”
Insolvent	An NBFI’s SACP or GCP is capped at 'cc' when it is in breach of legal regulatory minimum requirements and there are no prospects of it meeting the minimum requirements or of regulatory forbearance. Regulators may intervene before actual insolvency or to foster a recapitalization. When the descriptor is “insolvent,” CLE is “very weak.”

## Finance Companies

64. In our assessment of CLE for fincos, after analyzing regulatory capital, we next consider equity sufficiency through an assessment of risk-based capital or leverage. We then may factor in qualitative assessments of earnings, capital, and financial flexibility when the quantitative outcome is close to an assessment threshold. The CLE assessment for fincos is the outcome of tables 12-13 and paragraphs 72-78, unless the regulatory capital assessment is "at risk" or worse, in which case, table 11 applies. If the risk-adjusted capital (ratio) described in table 12 falls within 50 basis points of a threshold, or if the ratio described in table 13 falls within 0.5x of a threshold, then the quantitative analysis is complemented by the qualitative assessments to determine the overall CLE assessment.

### 1) Regulatory capital

65. We assess regulatory capital according to the same methodology for both fincos and securities firms (see paragraph 63 and table 11).

### 2) Capital or leverage

66. For fincos, we assess either capital or leverage, depending on which we believe best represents our forward view of a firm's capital sufficiency to protect obligors given the finco's projected asset and operational risks. Typically, capital is assessed through the risk-adjusted capital (RAC) ratio, which is the risk-adjusted measure of capital adequacy that we apply to banks. We assess leverage, which is not risk-adjusted, through the leverage ratio described in paragraph 70. RAC is defined in "Risk-Adjusted Capital Framework Methodology," published July 20, 2017, and both metrics are adjusted according to "Hybrid Capital: Methodology And Assumptions," published July 1, 2019, to account for the loss-absorption capacities of hybrid capital.
67. Since RAC is not specifically calibrated for fincos, we address relevant differences in the risk position assessment.
68. Total adjusted capital (TAC) is the numerator of the RAC ratio, and risk-weighted assets (RWAs) is the denominator of the ratio. Absent robust publicly available data to calibrate a framework for global loss rates for nonbanks, RAC provides a starting place for our analysis of capital. Since asset loss assumptions in RAC are not calibrated for nonbanks, we incorporate risks not covered in RAC in the "Risk Position" section for fincos and in the "Capital, Leverage, And Earnings" section for securities firms. For more details, see "Risk-Adjusted Capital Framework Methodology," published July 20, 2017.

Table 12

### Assessing A Finco's Capital Or Leverage Based On The Risk-Adjusted Capital (RAC) Ratio\*

RAC ratio (%)	Capital or leverage assessment
15 and above	Very strong
10-14.99	Strong
7-9.99	Adequate
5-6.99	Moderate
3-4.99	Weak

Table 12

**Assessing A Finco's Capital Or Leverage Based On The Risk-Adjusted Capital (RAC) Ratio\* (cont.)**

RAC ratio (%)	Capital or leverage assessment
Below 3	Very weak

\*If the finco's RAC ratio is within 50 basis points of a cutoff point in this table (for example, within 9.5%-10.5%), the "CLE qualitative assessments" section also applies.

69. We base the CLE assessment on leverage when assets, underwriting practice, recovery prospects on defaulted assets, or asset value protection arrangements (such as collateral arrangements or stop-loss arrangements) are sufficiently different from banks for us to consider RAC, in combination with risk position, to be an insufficient proxy for the financial risk emanating from the firm's balance sheet. Examples include:
- Fincos with nontraditional assets, such as those not easily securitized, assets with high Basel Committee regulatory capital charges, and assets with low or no observable liquidity (for which prices are not available through widely used trading data information providers).
  - Fincos with assets that have a much higher likelihood of experiencing losses relative to the loss expectations made in the RAC analysis. Types of assets could include unsecured or leveraged commercial loans (those not secured by specific assets), subordinated or mezzanine debt (assets or loans offered), highly leveraged assets secured by real estate, and other high-yielding assets that banks typically do not hold.
  - Fincos that have a much lower likelihood of experiencing losses relative to the loss expectations made in the RAC analysis. We expect this outcome to be infrequent.
  - When a finco's business model is significantly more targeted to achieving capital gains through investment and trading strategy, as opposed to spread lending (where interest income exceeds the cost of funding, resulting in a positive net interest margin).
70. We measure leverage by debt to adjusted total equity (ATE) (see table 13). To derive ATE, we adjust total equity by subtracting out equity in unconsolidated subsidiaries or those that we believe the company is unlikely to support in a stress situation. This enables us to capture equity that we believe will be available to cover losses that fincos may incur. When we subtract out equity in any consolidated subsidiaries, we also subtract out any associated nonrecourse debt that has been consolidated on the balance sheet. Finally, we add general reserves to equity.

Table 13

**Assessing A Finco's Capital Or Leverage Based On The Leverage Ratio\***

Leverage ratio (debt to ATE§) (x)	Capital or leverage assessment
0-1.5	Very strong
1.51-2.75	Strong
2.76-4.5	Adequate
4.51-6.5	Moderate
6.51-12	Weak
>12	Very weak

\*If the finco's ratio is within 0.5x of a cutoff point in this table (for example, within 4.0x-5.0x), the "CLE qualitative assessments" section also applies. §See paragraph 70 for the calculation.

71. In assessing RAC or leverage ratios, we reflect our expectations for the balance sheet, including both earnings and anticipated capital management initiatives (such as raising additional equity or paying dividends), over a two-year horizon, with primary emphasis on the current year. We also take into consideration:
- Developments since the most recent public or nonpublic information was released, such as dividend payments, new debt issuance, and repayment of existing debt;
  - Negative developments that we expect, such as increased debt, planned dividends and share repurchases, increased investment risk, and anticipated faster growth in the risk portfolio of the firm (such as in asset exposures) than previously observed;
  - Positive developments that we view as having a reasonably high degree of certainty, such as expected retained earnings or repayments of existing debt. A finco's plans for equity market or hybrid capital instrument issuance, or reductions in investment risk, would rarely carry a reasonably high degree of certainty; and
  - Our forward view, which may differ from company projections.

### **3) CLE qualitative assessments**

72. When a firm's capital or leverage assessment is within 50 basis points of a threshold (including on a cutoff point for a threshold) for the RAC ratio (per table 12), or within 0.5x of a threshold (including on a cutoff point for a threshold) for leverage (per table 13), the criteria apply two qualitative assessments:
- Earnings, and
  - Quality of capital and financial flexibility.
73. If an issuer's RAC ratio is 50 bps below a RAC threshold or 0.5x above a leverage threshold (meaning capital would typically be scored in the weaker of the two adjacent categories), we may still assign the stronger CLE assessment if we believe all of the following apply:
- The issuer, because of strong and stable earnings, has a high capacity to absorb losses through the credit cycle--meaning that its earnings before credit and market losses are likely to exceed credit and market losses even when those charges peak in the credit cycle;
  - The issuer generates sufficient earnings to support its balance sheet growth without substantial increases in leverage; and
  - The issuer's quality of capital and financial flexibility is "high," as described in paragraph 78.
74. If an issuer's RAC ratio is 50 bps above a RAC threshold or 0.5x below a leverage threshold (meaning capital would typically be scored in the stronger of the two adjacent categories), we may still assign the weaker CLE assessment if we believe any of the following apply:
- The issuer, because of weak or volatile earnings, has a poor capacity to absorb losses through the credit cycle--meaning that credit and market losses will likely exceed earnings before such charges at points in the credit cycle;
  - The issuer doesn't generate sufficient earnings to support its balance sheet growth without substantial increases in leverage; or
  - The issuer's quality of capital or financial flexibility is poor.

## i) Earnings

75. The first step in assessing earnings is to analyze the historical and expected level and volatility of two operating ratios: return on average assets (ROAA) and core earnings on average adjusted assets (see Glossary). When assessing earnings we will consider:
- The level of the two metrics relative to the entity's credit and market risks, and
  - The vulnerability of the two metrics to changes in operating conditions.
76. In assessing the volatility of the two metrics above--and how an issuer's credit and market risks and operating efficiency affect its earnings--we consider factors such as the following (noting that an individual factor could drive the assessment):
- The level of stable net interest income and stable fee income relative to revenues;
  - Core earnings relative to RWAs (when using RAC); and
  - Trading gains and other market-sensitive income to total revenues.
77. We also consider any other factors that diminish or enhance an issuer's earnings and its ability to absorb losses through the credit cycle.

## ii) Quality of capital and financial flexibility

78. Quality of capital and financial flexibility is typically "high" when all of the following apply:
- Core capital, as measured by adjusted common equity, comprises more than 90% of the TAC, or double leverage is less than 90%;
  - Covenant, legal, tax, regulatory, or other characteristics of the group structure (for example, minority interests) are not a significant constraint on the flow of loss-absorbing capital among group members;
  - No indications exist that private equity, management, or shareholders may reduce or prevent the maintenance of capital;
  - Capital metrics would not be eroded by any of the following: repayment of government-contributed equity, recognition of any currently unrecognized economic losses, reduction from capital the amount necessary to appropriately capitalize any materially undercapitalized unconsolidated subsidiaries, and reversal of any property valuation adjustment; and
  - At least one of the following applies: shareholders are supportive of strong capital, with lower expectations for dividends and share buybacks; the firm has concrete commitments from outside parties to provide it with material amounts of loss-absorbing capital that practically can be exercised while still a going concern; or the firm is at least adequately capitalized and a committed strong financial partner or backer bolsters financial flexibility.

## Securities Firms

79. In our assessment of CLE for securities firms, after analyzing regulatory capital, we consider:
- Capital and leverage,



- Earnings, and
- Earnings buffer.

80. To determine the CLE assessment, we evaluate both capital and leverage, and earnings, and then combine those two assessments (see table 14). Weak regulatory capital can cap the CLE assessment at "weak" or "very weak," as well as the SACP (as it does for fincos, see table 11). If table 14 indicates two possible outcomes, then our assessment of a securities firm's earnings buffer determines which of the two applies.

Table 14

**Capital, Leverage, And Earnings (CLE) Assessment For Securities Firms**

--Capital and leverage assessment (from paragraphs 82-97)--	--Earnings assessment (see paragraphs 98-107)--			
	Strong	Adequate	Moderate	Weak
<b>Very strong</b>	Very strong	Very strong	Very strong or strong	Strong or adequate
<b>Strong</b>	Strong	Strong	Strong or adequate	Adequate
<b>Adequate</b>	Strong or adequate	Adequate	Adequate or moderate	Adequate or moderate
<b>Moderate</b>	Adequate or moderate	Moderate	Moderate	Moderate or weak
<b>Weak</b>	Moderate or weak	Weak	Weak	Weak or very weak
<b>Very weak</b>	Weak or very weak	Very weak	Very weak	Very weak

Note: When this table indicates two possible CLE outcomes, the earnings buffer assessment determines which prevails (see paragraphs 108-112).



Table 15

Summary: Assessing A Securities Firm's Capital, Leverage, And Earnings (CLE)		
<b>1) Regulatory capital adequacy (table 11) caps CLE at "weak" or "very weak," or is neutral to CLE (paragraph 63)</b>		
<b>2) Capital and leverage assessment (paragraphs 82-97)</b>		
Leverage (paragraph 83)	Equity-to-assets ratio (see box 1)	If 3% or lower, caps capital and leverage and CLE at "moderate"; otherwise, is neutral
Capital (paragraphs 82 and 84-97)	Expected RAC (table 16) after incorporating the next two steps, if applicable	If the expected RAC ratio is below 3%, capital is "very weak." Otherwise, table 16 results in two possible capital assessments, and the analysis continues to the next step.
Capital: Risks not covered in RAC (negative or neutral) (paragraphs 87-89)	Risks not covered in RAC is "negative"	The capital assessment is the lower of the two possible assessments in table 16
	Risks not covered in RAC is "neutral"	The quality of capital and financial flexibility determines which of the two possible assessments in table 16 applies
Capital: Quality of capital and financial flexibility (paragraphs 90-92)	Quality of capital and financial flexibility is "high"	The capital assessment is the higher of the two possible assessments in table 16
	Quality of capital and financial flexibility is not "high"	The capital assessment is the lower of the two possible assessments in table 16
<b>3) Earnings assessment (paragraphs 98-107)</b>		
Earnings capacity (strong, adequate, moderate, or weak) (paragraphs 100-101)	"Run rate" earnings are assessed using table 17. It determines the overall earnings assessment to be input into table 14, unless modified by earnings quality.	The assessment is determined using table 17
Earnings quality (positive, neutral, or negative) (paragraphs 102-107)	Earnings quality is "positive"	That improves the assessment derived in the previous step by one category
	Earnings quality is "neutral"	That leaves the assessment derived in the previous step unchanged
	Earnings quality is "negative"	That weakens the assessment derived in the previous step by one category
Capital, leverage, and earnings (table 14)	The capital and leverage assessment and the earnings assessment are combined	Table 14 describes the CLE outcomes; when it indicates two possible assessments, we continue to the final step
<b>4) Earnings buffer assessment (paragraphs 108-112)</b>		
Earnings buffer	The earnings buffer is "positive"	This supports the higher of the two CLE outcomes in table 14
	The earnings buffer is "negative"	This could lead to a lower CLE assessment after recalculation and results in the lower of the two CLE outcomes after any recalculation.

## 1) Regulatory capital

81. We analyze regulatory capital according to the same methodology for both fincos and securities firms (see paragraph 63 and table 11).

## 2) Capital and leverage

82. In this part of the analysis, we first determine a securities firm's leverage and then assess the following components of its capital: the expected RAC ratio, risks not covered in RAC, and quality of capital and financial flexibility. Capital solely determines the capital and leverage assessment, unless the leverage ratio (as defined in box 1) is 3% or below, in which case the capital and leverage assessment and CLE assessment are "moderate" or weaker. If the expected RAC ratio is below 3%, capital is "very weak." If it is higher than 3%, table 16 indicates two possible outcomes. In that case, risks not covered in RAC and quality of capital and financial flexibility determine which of the two outcomes prevails.
- If risks not covered in RAC is "negative," then the capital assessment is the lower of the two possible outcomes in table 16.
  - If risks not covered in RAC is "neutral," then quality of capital and financial flexibility determines the assessment of capital. If quality of capital and financial flexibility is not "high," the capital assessment is the lower of the two possible outcomes in table 16. If it is "high," the capital assessment is the higher of the two possible outcomes.

Table 16

### Capital Assessment For Securities Firms\*

Expected RAC ratio (%)	Assessment
Below 3	Very weak
3-4.99	Weak or very weak
5-6.99	Moderate or weak
7-9.99	Adequate or moderate
10-14.99	Strong or adequate
15 and above	Very strong or strong

\*When this table indicates two possible outcomes, risks not covered in RAC (see paragraphs 87-89), and in certain cases quality of capital and financial flexibility (see paragraphs 90-92), determine which prevails.

## i) Leverage

83. As leverage increases, a securities firm is less able to absorb losses for a given amount of business activity and assets. Since securities firms often broker low risk-weight assets, RAC loss assumptions may underestimate losses since credit risk is low, but liquidation risk may be more meaningful to our capital assessment. Since securities firms typically have short-duration funding, high leverage limits the assessment of capital.

**Box 1**

**Leverage Ratio**

We calculate a securities firm's leverage ratio in one of the two ways below, based on the level of detail provided in financial reporting to address netting for reported balance sheet derivatives:

**A. Leverage ratio = ACE/adjusted assets**

For firms that report derivative positions net by counterparty (as under U.S. generally accepted accounting principles)

**B. Leverage ratio = ACE/(adjusted assets – 90% of derivatives receivables)**

For firms that report balance sheet derivatives on a gross basis (as under IFRS)

**ii) Expected RAC ratio**

84. We focus on a securities firm's expected RAC ratio, which anticipates the equity position and exposures (on and off balance sheet) in the coming year. S&P Global Ratings' RAC ratio compares an entity's capital to its RWAs, both defined as in our risk-adjusted capital framework (RACF) outlined in "Risk-Adjusted Capital Framework Methodology," published July 20, 2017. The RACF uses a globally consistent measure of capital, called TAC. We refer to the expected--and not projected--RAC ratio, in part because projected earnings are not included in the TAC used to calculate the expected RAC ratio (see box 2).
85. The RACF also applies S&P Global Ratings' risk weights to a firm's on- and off-balance-sheet exposures to produce the S&P Global Ratings RWAs. The risk weights applied to each risk type and asset class reflect their relative degree of risk, based on related sovereign ratings and BICRA risk parameters. For greater detail on how we apply the RACF for securities firms, see paragraph 86 and "Risk-Adjusted Capital Framework Methodology" (particularly the appendix "How To Compute Trading Risk RAC RWAs For Securities Firms"), as well as "Guidance: Applying The Risk-Adjusted Capital Framework Methodology," published Sept. 13, 2018.

**Box 2**

**Definition Of A Securities Firm's RAC Ratio**

$$\text{RAC ratio} = \text{TAC} \div \text{RWAs}$$

RAC--Risk-adjusted capital

TAC--Total adjusted capital, Standard & Poor's definition of capital

RWA--Risk-weighted assets, Standard & Poor's calculation of RWAs

86. We apply RACF to securities firms as we do for banks. We typically use a value at risk (VaR)-based methodology scaled up to our standards to assess securities firms' primary risk--market risk (see

appendix "How To Compute Trading Risk RAC RWAs For Securities Firms" in "Risk-Adjusted Capital Framework Methodology"). However, absent reliable data, we would typically apply the look-through method as detailed in paragraphs 122 and 123 of "Risk-Adjusted Capital Framework Methodology," published July 20, 2017.

[Box 3 has been deleted.]

### **iii) Risks not covered in RAC**

87. Assessment of risks not covered in RAC focuses on risks associated with a trading book, illiquid or difficult to value securities, and underwriting-related risk. The assessment is "negative" if one or more of the conditions in paragraph 89 apply, and is otherwise "neutral."
88. Risks not covered in RAC addresses factors that contribute to relative risk in a securities firm's capital, including:
- The reliability of information available to assess market risk;
  - The challenge of assessing prospective exposure levels, like intraday and intraperiod risks;
  - Risk associated with securities underwriting operations;
  - Material exposure to risks difficult to quantify such as trade technology risk; and
  - Risk of less liquid assets that are not well captured in RAC.
89. The risks not covered in RAC assessment is typically "negative" when a firm has one or more of the following:
- Less reliable information is used to calculate RAC (i.e., lack of regulatory validation of VaR for firms with material trading operations or that are highly leveraged).
  - Substantial business line risks are not covered by RAC (i.e., underwriting is "committed" and thus payment is obligated as opposed to a "best efforts" basis).
  - The firm's S&P Global Ratings RWAs and RAC results show outsize historical volatility (including due to seasonality).
  - Adjusting S&P Global Ratings' RWAs or TAC for the following would materially lower the RAC ratio: illiquid positions (e.g., illiquid currencies or illiquid stocks) for which the one-year capital horizon in the RAC framework is not appropriate; Level 3 assets in excess of 25% of TAC; significant risk of very low probability potential losses not captured by the 99%-VaR but captured by other metrics such as stress tests or expected shortfalls; asset-liability management (ALM) risk, pension risk, or other similar capital risks not fully captured in the RAC framework that we consider significant for the firm; and materially deficient loan loss reserves.
  - The firm does a very high volume of originations or trades relative to TAC, such as high-frequency trading firms that use models and automated principal trading technology to transact a very high volume of trades relative to their TAC.

### **iv) Quality of capital and financial flexibility**

90. Quality of capital and financial flexibility assesses additional capital strengths or weaknesses not captured in the expected RAC ratio.
91. The quality of capital and financial flexibility is typically "high" when all of the following apply:

## Criteria | Financial Institutions | General: Nonbank Financial Institutions Rating Methodology

- Core capital, as measured by adjusted common equity (ACE), comprises more than 90% of TAC, and double leverage is less than 110%;
  - Covenant, legal, tax, regulatory, or other characteristics of the group structure (for example, minority interests) are not a significant constraint on the flow of loss-absorbing capital among group members; and
  - There are no indications that ownership, private equity, or management may reduce or prevent the maintenance of capital levels.
92. In addition, the quality of capital and financial flexibility is typically "high" when the RAC ratio would not be eroded by any of the following: repayment of government-contributed equity, recognition of any currently unrecognized economic losses, deduction from capital the amount necessary to appropriately capitalize any materially undercapitalized unconsolidated subsidiaries, and reversal of any property valuation adjustment. Also, at least one of the following three conditions applies:
- Ownership is supportive of "strong" capital, reflected, in part, by maintaining non-dilutive actions, such as increased dividends or share buybacks.
  - The firm has concrete commitments from outside parties to provide it with material amounts of loss-absorbing capital that practically can be exercised while still a going concern.
  - The firm is at least adequately capitalized, and a committed strong financial partner or backer bolsters financial flexibility.
93. Here is an example that illustrates how we may assess capital under this framework:
94. The expected RAC ratio for a broker is 8%.
- Based on table 16, the RACF assessment is "adequate" or "moderate."
95. Quality of capital and financial flexibility is assessed as "high" because:
- The broker's ACE to TAC is 100%;
  - The broker has a simple, single-entity organization that makes all capital available to support core operations and risks;
  - Shareholders have been supportive of strong capital; and
  - The firm has no government-contributed equity and no material unrecognized economic losses, unconsolidated subsidiaries, or property valuation gains.
96. Risks not covered in RAC is assessed as "negative" because the broker has:
- A large portion of proprietary trading for which S&P Global Ratings' RWAs have been computed using the broker's own VaR model, which regulators have not validated;
  - An active equity and debt underwriting business done on a committed basis, which includes risks that the RAC ratio does not fully capture; and
  - Very volatile S&P Global Ratings RWAs from period to period.
97. Result: The broker's capital assessment is "moderate" (the lower of the two possible outcomes in table 16).

### 3) Earnings assessment

98. We don't project RAC for securities firms as we do for banks because securities firms' revenue and trading losses are less predictable than banks' net interest income and credit-based losses. Earnings can be very volatile if materially based on market-sensitive revenue. Market risk losses, when they occur, tend to be correlated (multiple loss positions occurring at once) and unpredictable. This lowers our confidence in the precision of our standard projection and incorporation of earnings into our RAC estimate. We believe the earnings assessment for securities firms addresses these weaknesses, and it can be "strong," "adequate," "moderate," or "weak."
99. Under the criteria, we assess earnings by first considering earnings capacity, and then earnings quality. Earnings capacity is assessed as per table 17 and forms the initial earnings assessment. Earnings quality is assessed "positive," "neutral," or "negative" and shifts the initial earnings assessment up if positive, or down if negative, by one category (for example, to "strong" from "adequate"), and leaves it unchanged if neutral. For securities firms operating for fewer than three years, the earnings assessment would solely reflect earnings quality and additionally would be capped at "adequate."

#### i) Earnings capacity

100. The earnings capacity assessment is based on our measure of risk-adjusted returns: S&P Global Ratings' core earnings over S&P Global Ratings' RWAs. We look at the average of the metric over the past three years, as assessed in table 17.
101. Our core earnings adjust for items we do not include in equity capital, such as own credit risk adjustment and derivative valuation adjustment, as well as amortization/impairment of goodwill. We also adjust for "special items" (nonrecurring income or expenses) because they do not recur and cannot be relied upon as a source of forward earnings.

Table 17

#### Earnings Capacity Assessment For Securities Firms

Assessment	Three-year average core earnings/RWAs
Strong	Over 200 bps
Adequate	75 bps to 199 bps
Moderate	25 bps to 74 bps
Weak	Below 25 bps

Bps--Basis points.

#### ii) Earnings quality

102. Earnings quality reflects current and prospective characteristics that are likely to lead to more or less stable earnings. Volatile earnings diminish our confidence in earnings' ability to provide a cushion against potential losses. Earnings derived from revenue that is driven by recurring sources and high expense flexibility support earnings stability over time. Earnings quality is "positive," "neutral," or "negative." If not "positive" or "negative," it is "neutral" and does not change the earnings assessment derived in table 17.



103. To assess earnings quality, we review:

- The flexibility of the expense base (i.e., the variability of expenses and capacity to lower expenses in response to lower revenues);
- Structural factors--inherent to the business model the firm chooses--that could affect the stability of revenues, such as the proportions of pretax earnings coming from a relatively narrow, highly unstable business line (such as investment banking) or performance-based revenues, recurring fee-based income, and principal trading activity;
- Whether the firm is in a restructuring or transformational mode, which would indicate the past is not necessarily a good predictor of the future; and
- The frequency of nonrecurring revenues or expenses.

104. For the following metrics, earnings quality improves as the ratio increases:

- Recurring income (from sources like non-trading-related net interest income and asset-based and other stable fees) to net revenue; and
- Net revenue from retail brokerage, retail banking, asset management, and agency services to net revenue.

105. Earnings quality deteriorates as each of the following increases:

- Trading income to total revenues,
- Investment banking revenue to net revenue,
- Other market-sensitive income to total revenues,
- Other revenues to total revenues,
- Cost-income ratio,
- Nonrecurring or special income to net revenue,
- Nonrecurring or special expense to net revenue, and
- Volatility of risk-adjusted returns.

106. Typically, two or more of the following characteristics lead to a "negative" earnings quality assessment:

- Relatively narrow, highly unstable, and/or correlated business lines (like investment banking or principal trading) are expected to regularly contribute a majority of earnings or substantial market-risk RWAs.
- The firm has had an annual loss from continuing operations in excess of 1x its average annual earnings (during non-loss years) over the past cycle or experiences outsize quarterly earnings volatility, including more frequent quarterly losses.
- There are indications of limited debt service capacity (i.e., very low or negative net interest margin and low earnings interest expense coverage).
- The firm has a history of frequent or outsize nonrecurring or extraordinary expenses or relies on one-off revenues (such as capital gains on securities or fixed assets) to sustain profitability in bad years.
- The expense base has low flexibility. An inability to adjust expenses when coping with lower revenues is an important weakness for a securities firm.

107. Typically, earnings quality is "positive" if we view the earnings capacity assessment as overly conservative because the firm meets at most one of the characteristics in the previous paragraph, and any of the following elements are expected to lead to more stable earnings and offset the characteristics in the previous paragraph:

- Relatively narrow, highly unstable, and/or correlated business lines (like investment banking or principal trading) are expected to regularly contribute no more than approximately one-third of earnings and market RWAs in normal periods.
- Recurring, stable revenue and earnings sources are expected to regularly account for a majority of revenue and earnings in almost all periods and conditions, or expense base flexibility is good relative to revenue volatility.
- The firm has had no more than minimal annual losses on continuing operations during or since the last cycle.
- Quarterly earnings volatility is on par with peers'.
- ALM mismatches are immaterial.
- We expect that the firm's low frequency/materiality of one-off revenues and cash expense items will continue.
- There are indications of strong debt service capacity (i.e., strong net interest margin and strong EBITDA interest expense coverage).
- The firm is in a restructuring or transformational mode that we believe will improve earnings stability.

#### **4) Earnings buffer**

108. The earnings buffer is core earnings plus provisions minus normalized losses all divided by RAC's RWAs. Normalized losses are defined in "Risk-Adjusted Capital Framework Methodology," published July 20, 2017. They represent our view of credit losses for a firm through the cycle. In a benign environment, credit losses are very likely to be lower than normalized losses so that the three-year average of core earnings to RWAs may represent a flattering picture of the earnings capacity of the firm.

109. We compute the three-year average of the earnings buffer. It can be "positive" or "negative." When it is negative, the RAC is recalculated net of the earnings buffer shortfall. This would lower the RAC ratio and, as a result, could lead to a lower CLE assessment. The assessment is the weaker of the two possible outcomes if this recalculation results in the new RAC ratio falling to within 50 basis points of an assessment threshold in table 16.

110. Here is an example of how the earnings buffer is used to derive the CLE assessment:

111. According to table 14, CLE is either "adequate" or "strong" because broker A has:

- "Adequate" capital and leverage assessment,
- 10.5% expected RAC ratio, and
- "Strong" earnings assessment.

112. The broker's earnings buffer is -60 basis points, which is deducted from the expected RAC ratio and results in a new RAC calculation of 9.9%. Because this is below the 10% level indicated for "strong" in table 16, the CLE assessment is "adequate."

## D. Risk Position

### Finance Companies

113. Risk position is the next SACP or GCP factor. It is a relative and highly qualitative assessment that refines our view of a firm's actual and specific risks beyond the conclusion arising from the standard assumptions in the CLE analysis. Those assumptions do not always reflect or adequately capture the specific risk characteristics of a particular finco. We consider the following six subfactors when assessing fincos' risk positions:

- Lending and underwriting standards,
- Loss experience,
- Risks not covered in RAC or leverage,
- Risk appetite,
- Complexity, and
- Diversity.

114. We assess risk position as "very strong," "strong," "adequate," "moderate," "weak," or "very weak." To determine that assessment, we first analyze a finco's lending and underwriting standards (relative to the lending and underwriting standards for banks in the same country) to arrive at the preliminary risk position assessment (see table 18). We then adjust the preliminary risk position for each of the five other subfactors. Loss experience can raise or lower the assessment by one category (for example, to "strong" from "adequate," or vice versa); risks not covered in RAC or leverage can raise the assessment by one category, or lower it by one or more; and risk appetite, complexity, and diversity can collectively lower the assessment by one or more categories. These adjustments apply cumulatively. If any subfactor or combination is sufficiently negative, it can, on its own, result in a risk position assessment of "weak" or "very weak," the determination of which results from an assessment of its implications for the reliability of the CLE assessment.

115. The last three subfactors--risk appetite, complexity, and diversity--assess whether the conclusions reached through the analysis of the first three subfactors overestimate capital sufficiency. If we assess these three subfactors as meaningfully negative (relative to the CLE assessment) and if they point to risks not already reflected in the first three subfactors or in CLE, we typically lower risk position by two categories. If one or two are assessed as negative and those risks are considered important (relative to the CLE assessment) and not already reflected in the first three subfactors, risk position is typically lowered by one category.

#### Finance Company Lending And Underwriting Standards

One subfactor assessed in BICRA is the lending and underwriting standards applicable in a country. We leverage that to consider finance company assumptions relative to banks' in each country. We do this to compensate for RAC assumptions that have not been recalibrated for nonbanks. We presume that NBFIs must compete with banks and must increase risk tolerances to generate higher income required to offset a higher cost of funding relative to banks. But some fincos may simply operate in areas where banks don't and are not pushed to take additional risk. Others operate in higher risk products but underwrite more conservatively to compensate. This can result in fincos having lending and underwriting standards that are superior to those of banks in a country.

## 1) Lending and underwriting standards

<sup>116</sup> First, we compare a finco's lending and underwriting standards with those of banks in the same country (see table 18). The assessments for lending and underwriting standards are "at least moderately conservative," "relaxed," and "aggressive" (see table 19), the same as for banks under our bank criteria. Underwriting to a weaker standard than that of the typical bank suggests that the loss assumptions in RAC underestimate potential losses. If a finco is considered to have superior lending and underwriting standards relative to the typical bank, an assessment of "strong" or "very strong" is possible for the preliminary risk position. Fincos often do not underwrite the same assets as banks and focus on niches. We use the bank standards to consider what level a finco would write to if it were to underwrite the same types of assets as banks given what we see in the standards applied to the asset classes the finco finances. This is a qualitative assessment guided by the language and parameters outlined in table 18 (bank table 19), among other factors.

Table 18

### Assessing A Finco's Preliminary Risk Position: Lending And Underwriting Standards

--BICRA assessment of lending and underwriting standards for banks in the finco's jurisdiction--	--Finco-specific assessment of lending and underwriting standards applying table 19 --		
	At least moderately conservative	Relaxed	Aggressive
At least moderately conservative	Adequate	Moderate	Weak
Relaxed	Strong	Adequate	Moderate
Aggressive	Very strong	Strong	Adequate

Table 19

Adjustment For Lending And Underwriting Standards	
Category	Description
<b>At least moderately conservative</b>	<p><b>Moderately conservative lending and underwriting standards</b></p> <ul style="list-style-type: none"> <li>• Share of new residential mortgage lending above 80% LTV: 0%-30%.</li> <li>• Average indexed LTV for the residential mortgage portfolio: below 60%.</li> <li>• Underwriting standards for mortgage lending are based on multiple factors, including at least moderately conservative cash-flow requirements and collateral values.</li> <li>• Minimal mortgage lending other than prime.</li> <li>• Limited concentration in cyclical or vulnerable sectors: guideline below 8%.</li> <li>• Limited concentration in real estate construction and development: guideline below 8%.</li> <li>• Limited single-name concentration.</li> <li>• Limited foreign-currency lending: below 20% or moderate vulnerability due to a stable and credible peg to the currency of foreign-currency lending.</li> <li>• No or very low use of securitization and derivatives to shift risks off balance sheet.</li> </ul>
<b>Relaxed</b>	<p><b>Relaxed lending and underwriting standards</b></p> <ul style="list-style-type: none"> <li>• Share of new residential mortgage lending above 80% LTV: 30%-60%.</li> <li>• Average indexed LTV for the residential mortgage portfolio: 60%-75%.</li> <li>• Underwriting standards for mortgage lending may be based on a multiple of factors, including cash flow requirements and collateral values.</li> <li>• Some mortgage lending other than prime (buy-to-let, subprime etc.).</li> <li>• Concentration in cyclical or vulnerable sectors: 8%-15%.</li> <li>• Concentration in real estate construction and development: 6%-15%.</li> <li>• Some single-name concentration.</li> <li>• Foreign-currency lending: 20%-40% and high vulnerability due to a possible fall in local currency.</li> <li>• Some use of securitization and derivatives to shift risks off balance sheet (originate-to-distribute model).</li> </ul>
<b>Aggressive</b>	<p><b>Aggressive lending and underwriting standards</b></p> <ul style="list-style-type: none"> <li>• Share of new residential mortgage lending above 80% LTV: above 60%.</li> <li>• Average indexed LTV for the residential mortgage portfolio: above 75%.</li> <li>• Underwriting standards for mortgage lending would typically be based on collateral values only.</li> <li>• Important mortgage lending other than prime (buy-to-let, subprime).</li> <li>• Concentration in cyclical or vulnerable sectors: above 15% of total loans.</li> <li>• Concentration in real estate construction and development: above 15% of total loans.</li> <li>• Significant single-name concentration.</li> <li>• Foreign-currency lending: above 40% and very high vulnerability due to a possible fall in local currency.</li> <li>• Broad use of securitization and derivatives to shift risks off balance sheet (originate-to-distribute model).</li> </ul>
<p>Note: This is taken from table 10 of "Banking Industry Country Risk Assessment Methodology And Assumptions," published Nov. 9, 2011.</p>	

## 2) Loss experience

117. Typically, if a finco's loss experience is superior to peers' (i.e., indicating lower losses) and if we expect the finco's losses to remain below peers' and below the RAC loss assumptions or below those of peers with similar leverage, the loss experience subfactor would strengthen the risk

position assessment by one category. If loss experience is inferior to peers' and exceeds RAC loss assumptions or exceeds those of peers with similar leverage, and if we expect this to continue, risk position is typically one category weaker.

### 3) Risks not covered in RAC or leverage

118. Risks not covered in RAC or leverage analyzes four indicators for fincos: interest rate and currency risk, volatility of employee-benefit obligations funding, operational risk, and asset quality.
119. If any one of the first three indicators signals losses that materially exceed those assumed in our projected RAC ratio, risk position is typically one category weaker. If the risk is significant, or if this is the case for more than one of the risks, risk position is weaker by two or more categories unless one or more strengths clearly outweigh the weaknesses, in which case the risk position would only be weaker by one category.
120. Asset quality exceeding that of peer fincos can strengthen the risk position assessment by one category, and asset quality that is worse than peer fincos' can weaken risk position by one category. Our assessment of asset quality is based on the current and expected level of nonperforming assets. Strong asset quality can lead to an improvement in the risk position assessment--if we have not already factored in this improvement in the loss experience section. However, we typically will not strengthen the risk position because of strong asset quality if we have already strengthened it because of good loss experience. We would only do so when we believe the inherent risk of an issuer's assets is lower than that reflected in our RAC or leverage measure and if we believe the issuer has demonstrated a track record of managing that risk through good underwriting.

#### i) Interest rate and currency risk in the balance sheet

121. The assessment of interest rate risk includes interest rate risk based on the nature of assets and interest rate risk that stems from funding choices (such as short maturity funding for long maturity assets).
122. The analysis of interest rate risk includes a review of:
  - The sensitivity of a finco's projected earnings to changes in interest rates or the shape of the yield curve based on its own stress testing;
  - Senior management's engagement and awareness for setting and managing the amount of interest rate risk;
  - The degree of maturity gap between repricing assets and liabilities; and
  - The adequacy of a finco's risk management based on a review of its scenario and stress testing, as it pertains to any shift in interest rates throughout the market, exposure of assets or funding liabilities with embedded options held by counterparties including prepayment or extension options, or other behavioral characteristics that differ from contractual ones.
123. Currency risk arises when assets in the loan portfolio and the finco's funding are held in different currencies that are not hedged. The assessment of currency risk may include an examination of projected earnings to changes in currency exchange rates based on a finco's own stress testing. A finco's risk position is weaker when its currency risk is higher than for peers with similar economic risk.

## ii) Volatility of employee-benefit obligations funding

124. The RACF criteria adjust for postretirement benefit obligations in line with table 3 of "Risk-Adjusted Capital Framework Methodology," published July 20, 2017. Risk position is assessed lower if the finco faces additional risk from potential movements in the values of the scheme's assets and liabilities, particularly for defined benefit pensions, and the view is that RAC does not otherwise capture this risk.
125. This additional risk depends on the size of the scheme's liabilities; key actuarial assumptions, including the investment return assumptions, life expectancy, or future salary increases; and other variables, such as the investment policy and amount of reinsurance used. When the size of the scheme's liabilities is large, a minor change in one of these variables can have a material impact on an NBF's financial strength.

## iii) Operational risk

126. In this part of the analysis, we assess the extent to which a finco's operating risks are adequately captured in our capital and leverage assessments. Examples include losses attributable to technology failures, employee mistakes, or legal action.
127. This assessment generally is neutral when our analysis indicates that a finco has adequate systems, policies, and practices to manage its operational risks. If we were to identify a finco as having material operating risks, inadequate systems, policies, or practices, we lower our overall risk position assessment. (For example, regulatory action or litigation related to consumer protection shortcomings could weigh on our assessment.) Also, our assessment would be lower if a finco experiences material--or less material, but frequent--operational risk losses (for example, due to cyber attacks).

## iv) Asset quality

128. Asset quality assesses the degree to which nonperforming assets or loss reserves are higher or lower than peers'.

## 4) Risk appetite

129. Over time, a management's risk appetite and tolerance is typically observed in quantifiable measures of risk. However, we take a prospective view of risk, which management's demonstrated risk appetite and tolerances inform. We also seek to look through what may be temporary, environmental variations in risk metrics to assess the longer-term risk profile.
130. Risk appetite is assessed through a review of recent trends in risk measures and management's stated risk goals to determine whether a firm's risks are growing or shrinking materially. We consider the degree to which these are indicative of a material change in risk appetite or tolerance or simply a response to short-term environmental factors. If we are convinced that there is a material and lasting alteration in risk trends, we would lower our assessment of risk position by one or two categories. For instance, as risk appetite increases, the reliability of assumptions made in the RAC ratio decreases. Risk appetite that decreases the reliability of assumptions made in the RAC ratio also lowers risk position by one category, or more than one category if considered particularly significant.

## 5) Complexity

131. Complexity can either be neutral to or lower our assessment of risk position. Greater scale may bring diversification benefits but also increase complexity. The ever-increasing complexity in products, business lines, regions, regulation, and organizational structure has often outstripped the capacity of management to manage risk. Complexity lowers risk position by one category if it highlights that CLE is underestimating risk. Complexity may lower the risk position assessment by more than one category if it is considered particularly significant.
132. However, fincos tend to be smaller or niche and less complex companies. The absence of complexity is reflected in transparent and straightforward risks that are well-understood and well-managed compared with peers.

## 6) Diversity

133. The final subfactor of risk position is an assessment of diversity of risk exposures. Risk concentrations may pose material risk and have, in some cases, been a primary contributor to past finco defaults. Some fincos have demonstrated that diversity of risks has led to lower overall losses than those for less diverse peers. As such, the risk position factor focuses on the concentration of exposures to individual borrowers, counterparties, industries or sectors, and aggregations of risk across asset classes and risk types. Concentration to any of these would expose a firm to unexpected changes in the creditworthiness of borrowers and counterparties, for example, or a shift in profitability of an industry or sector. Diversity is assessed in risk position relative to assumptions made in CLE. If we determine that a finco has concentration risks that aren't captured in CLE, we lower risk position depending on the magnitude of this negative diversity. Business position also captures concentrations of revenue contribution by business line, and that is separate from the CLE assessment in which concentrated earnings sources are an indicator of potentially low-quality earnings.
134. In analyzing a finco's diversity, if we deem that one or more of the following apply, and if they are considered particularly significant, we lower risk position by one category (for example, to "moderate" from "adequate"). If we believe that a majority of the following apply, and if one or more are considered particularly significant, we lower risk position by two categories.
- Risk exposures by sector, country, or single name in the loan portfolio, investment portfolio, or, if relevant, the trading book, are significantly more concentrated than for peers with a similar BICRA economic risk score. This could occur, for example, if the finco has significantly more concentrated exposures to sectors with high climate transition risks.
  - The finco transacts with a limited number of counterparties and maintains a material amount of counterparty exposure in contracts such as derivatives, lending facilities, or repurchase agreements with margin arrangements or other potential exposure.
  - It is highly likely that the finco will need to monetize illiquid investments required to meet liquidity obligations (debt, interest, and swap payments due in the coming 365 days).
  - The finco's RAC ratio after adjusting for concentration or diversification of risk exposures is materially lower than before concentration or diversification adjustments.
135. We assess material risk concentrations through two metrics:
- ATE compared with the largest 20 obligor exposures, and
  - Regulatory capital (when applicable) compared with the largest 20 obligor exposures.



## Securities Firms

136. For securities firms, risk position--the third SACP factor--refines our view of a firm's specific risks beyond the conclusion arising from the CLE analysis. We consider risk position relative to CLE as well as the anchor. We assess the following four risk position subfactors for securities firms:

- Principal risk management,
- Risk appetite,
- Risk concentration, and
- Complexity.

137. Together, the subfactors capture the degree to which the standard risk assumptions under- or overstate a securities firm's specific risks. Although we assess each independently, they may reinforce or weaken each other to determine risk position (see table 20). If credit and market risk management, one of two indicators for principal risk management, is assessed as "adequate" and the other indicator, loss experience, is assessed as "strong," principal risk management is typically assessed "strong" and risk position typically is assessed "strong," unless offset by risk appetite or another subfactor. Principal risk management and risk position can be assessed as "very strong" if the loss experience indicator is assessed "very strong" and credit and market risk management is considered "adequate" (see table 20). Principal risk management is capped at "adequate" if credit and market risk management is assessed below "adequate."

138. The descriptive characteristics in table 20 are applied on a "best-fit" basis, but the following usually applies:

- If principal risk management is assessed as less than "adequate," it will usually anchor the risk position assessment. For instance, a "moderate" principal risk management assessment for a firm with material principal risk limits risk position to "moderate," regardless of the other indicator assessments.
- If principal risk management is assessed as "adequate," the risk appetite subfactor assessment is most likely to be the reason for any modification of the overall assessment, in particular when it indicates material additional risk, or less risk.
- If principal risk management is assessed as "adequate" and risk appetite is "adequate," then risk concentration typically determines the assessment. If risk concentration is "adequate," then complexity typically determines the assessment when either represents material risks not already reflected in the assessment.

139. For example, firm A has an "adequate" CLE assessment and:

- Principal risk management is "adequate";
- Risk appetite is "adequate";
- Risk concentration is "adequate"; and
- Complexity is "moderate" because the firm is a high-frequency trading firm using automated and model-driven strategies for most of its revenue.

140. Based on this, firm A's risk position assessment is "moderate."

Table 20

Risk Position Assessment For Securities Firms*		
Score	What it means	Guidance
<b>Very strong</b>	A firm is able to withstand economic stress significantly better than the CLE assessment and anchor indicate.	<p>Risk position is assessed "very strong" when:</p> <ul style="list-style-type: none"> <li>• The principal risk management assessment is "very strong" due to credit and market risk management being assessed "adequate" and loss experience is expected to be materially below (better than) peers' and RAC assumptions (and this expectation is supported by past experience during periods of economic stress);</li> <li>• A "very strong" risk appetite assessment indicates substantially lower or shrinking risk appetite or exposure relative to what is captured in RACF; and</li> <li>• Neither risk concentration nor complexity represents risk sufficient to offset these strengths.</li> </ul>
<b>Strong</b>	A firm is able to withstand economic stress somewhat better than the CLE assessment and anchor indicate.	<p>Risk position is assessed "strong" when one of the following two combinations applies:</p> <ul style="list-style-type: none"> <li>• The principal risk management assessment is "strong" due to credit and market risk management being assessed "adequate" and loss experience being assessed "strong" because it is expected to be below (better than) peers' and RAC assumptions (and this expectation is supported by past experience during periods of economic stress); or</li> <li>• A "very strong" risk appetite assessment indicates substantially lower or shrinking risk appetite and exposure relative to what is captured in RACF, principal risk management is "adequate" and losses are expected to be materially below peers' and RAC's assumptions, and risk concentration or complexity (either individually or together) lowers the assessment below "very strong" because they represent risk sufficient to partially offset the other strengths.</li> </ul>
<p>*For firms where electronic trading is expected to account for more than 80% of revenue over the long term, risk position is limited at "moderate," unless capital is "very strong" and principal risk management is "adequate" or higher.</p>		

Table 20 (continued)

Risk Position Assessment For Securities Firms*		
Score	What it means	Guidance
<b>Adequate</b>	A firm's exposure to economic risk is adequately reflected in the CLE assessment and anchor.	Risk position is assessed "adequate" when one of the following applies: <ul style="list-style-type: none"> <li>• The risk appetite assessment is "adequate" (because it is consistent with historical levels and peers<sup>141</sup>); or</li> <li>• If the risk appetite assessment is above or below "adequate," the positive or negative indicators are offset by strengths or weaknesses (most likely in loss experience or possibly risk concentration or complexity).</li> </ul>
<b>Moderate</b>	A firm's exposure to economic risk is higher than what is reflected in the CLE assessment and anchor.	Risk position is assessed "moderate" when any one of the following five applies: <ul style="list-style-type: none"> <li>• Principal risk management is assessed below "adequate;"</li> <li>• If principal risk management is "adequate," loss experience exceeds peers' losses and risk appetite is assessed "adequate" or lower;</li> <li>• Irrespective of loss experience or principal risk management, the risk appetite assessment is below "adequate;"</li> <li>• Risk concentration is below "adequate," and this risk is not offset by a "strong" or "very strong" risk appetite assessment or lower losses relative to those of peers; or</li> <li>• Complexity materially adds to or obscures risk and is assessed "moderate" or weaker, and this risk is not offset by loss experience or risk appetite being assessed "strong" or "very strong."</li> </ul>
<b>Weak</b>	A firm is far less able to withstand economic stress than indicated by the CLE assessment and anchor.	Risk position is assessed "weak" when any one of the following three applies: <ul style="list-style-type: none"> <li>• "Weak" loss experience confirms "weak" principal risk management, and risk appetite, risk concentration, or complexity is assessed "adequate" or weaker;</li> <li>• "Very weak" principal risk management is offset by losses that are lower than or equal to peers' when risk appetite is assessed above "adequate" or when risk concentration is "very strong" (which is rare); or</li> <li>• Risk appetite is assessed as "weak" (and no other subfactor can offset this weakness, including an "adequate" assessment of principal risk management).</li> </ul>
<b>Very weak</b>	A firm's risk exposure is outside and substantially in excess of what's reflected in the CLE and anchor and represents a material rating weakness.	Risk position is assessed "very weak" when at least one of the following three applies: <ul style="list-style-type: none"> <li>• Principal risk management is assessed "very weak" and any of the other subfactors is not assessed "strong;"</li> <li>• Risk appetite is assessed "very weak" and none of the other subfactors are "strong;" or</li> <li>• Risk concentration or complexity is assessed "very weak" and either of principal risk management or risk appetite is below "moderate."</li> </ul>
*For firms where electronic trading is expected to account for more than 80% of revenue over the long term, risk position is limited at "moderate," unless capital is "very strong" and principal risk management is "adequate" or higher.		

141. When assessing a firm's risk position, we factor in our near- and medium-term outlooks for the sector's key macroeconomic factors (market conditions, economic trends, and other operating trends) to assess the firm's exposures and management's risk appetite and positioning, which may increase the likelihood of losses.

## 1) Principal risk management

142. Principal risk management addresses how well an entity manages the principal risks it faces: credit and market risks. Successful principal risk management is confirmed through loss history comparable or superior to peers' and loss expectations equal to or below RACF calculations of normalized losses. We assess the subfactor by analyzing two indicators:
- Credit and market risk management (as "adequate," "moderate," "weak," or "very weak"), and
  - Loss experience (as "very strong," "strong," "adequate," "moderate," "weak," or "very weak").
143. If credit and market risk management is assessed below "adequate," it caps principal risk management at "adequate." If losses exceed those of peers and if we expect that they'll exceed RACF assumptions, principal risk management likely would be below "adequate."

### i) Credit and market risk management

144. Credit and market risk management assesses a securities firm's risk oversight and control capabilities, as well as its management of reporting on principal market, credit, and counterparty credit risks. We analyze a firm's risk management capabilities relative to the nature and complexity of its exposures and management's stated risk appetites. (We consider a firm's discipline pertaining to risk appetite separately as the second subfactor of risk position.) The credit and market risk assessment is made in the context of the trading profit and losses compared with VaR limits, as well as risk managers' authority and oversight and ability to monitor and control limits in real time.
145. An "adequate" credit and market risk management assessment is supported by written policies and procedures, dedicated personnel, and infrastructure to support management of principal risk; written policies and procedures are accompanied by observation that they work (demonstrated by loss experience being assessed "adequate" or better). An "adequate" credit and market risk assessment is supported by not only a lack of deficiencies in risk oversight, but also model validation (internal or external) and other stress-testing policies and procedures, including back testing and adjustments to VaR methodology, assumptions used in risk assessment measures, and stress testing. For firms with credit and market risk management deficiencies, the assessment of credit and market risk management is "moderate," "weak," or "very weak" based on the extent of a firm's deficiencies in monitoring and controlling risk. Examples of credit and market risk management deficiencies include:
- Incomplete scope or reach of risk-monitoring capabilities, including record keeping that lacks complete, detailed evidence of when material breaches of control or policies occur and of how they are remedied, as well as inaccurate risk measures (each of these features weakens the credit and market risk management assessment);
  - A high number of back-testing exceptions;
  - Exceedance of stated risk limitations (i.e., securities inventory aging, position losses, margin rules, or desk position size);
  - A substantial gap between the highest observed VaR and the average VaR in recent periods (and volatility in VaR figures in general);
  - Material market risk exposures not captured in VaR or other measures; and
  - Risk limits that frequently change or are outsize on an individual trader or desk basis.

## ii) Loss experience

146. Loss experience supports the principal risk management assessment in the presence of all of the following:
- Low recent and low expected losses relative to the RACF calculation of normalized losses,
  - Low recent and low expected losses relative to those of peers with a similar economic score and similar product mix, and
  - A better-than-average track record of losses during periods of similar economic stress.
147. Conversely, loss experience lowers the principal risk management assessment to "weak" or "very weak" in the presence of:
- Losses that exceed the average for peers with a similar economic risk score and similar product mix, or
  - Track record of higher-than-average losses during recent periods of economic stress.
148. Even if a securities firm's loss experience exceeds peers', we could still consider loss experience neutral to the assessment if losses are due to a combination of growth, concentration, and complexity (see paragraphs 157-167).
149. Examples of weakness relative to peers include:
- Credit provisioning and loss recognition that may be more or less aggressive than for peers;
  - Volatility in the equity portfolio that suggests that the RACF may underestimate capital needs;
  - Legal or regulatory costs or fines that can be higher than for peers in the same lines of business;
  - Material insurance business (more than 10% of earnings) that can be undercapitalized compared with the rest of the group; and
  - Above-peers trading losses.

## 2) Risk appetite

150. The second subfactor of the risk position analysis addresses material increases or reductions in prospective risk that the RACF does not capture. (Risk appetite is assessed as "very strong," "strong," "adequate," "moderate," "weak," or "very weak.") We assess it through two indicators: risk tolerance (assessed "very strong," "strong," "adequate," "moderate," "weak," or "very weak") and growth and changes in exposure (supports higher or lower risk appetite but is not assigned an assessment). The risk appetite assessment supports a weaker risk position when management's risk appetite or trends in risk exposures indicate additional prospective risk not reflected in the RACF. A better assessment (i.e., which reflects a material reduction in prospective risk relative to RACF results) supports a stronger overall risk position.
151. Recent trends in risk measures help in assessing whether a firm's risks are increasing or materially shrinking, for example:
- Aggressive or increasing risk appetite is likely to cause recent risk measures and the expected RAC to understate risk and, thus, suggests a lower risk position assessment.
  - Management's risk appetite and trends in risk exposures are assessed relative to the level and

trends of risk appetite of peers and relative to the firm's historical patterns, as well as examples of long periods of material growth or reduction in risk.

- Risk appetite weighs on risk position when it is more aggressive than that of peers or is increasing.

152. Risk appetite is assessed "very strong" and supports a risk position assessment of "very strong" only when it indicates that the risk appetite and recent trends will substantially lower prospective risk. A "very strong" assessment applies solely for securities firms that have an external source of oversight of risk exposure emanating from a bank-like level of regulatory oversight and audited regulatory reporting or other strong evidence of external oversight. Risk appetite is assessed "strong" when risk appetite and recent trends will substantially lower prospective risk but there is no external source of oversight of risk exposure. Risk appetite is assessed "moderate," "weak," or "very weak" when its indicators suggest higher risk relative to peers' or suggest RAC may overstate capital sufficiency.

### **i) Risk tolerance**

153. Risk tolerance assesses the trade-off between profitability and risk during periods of heightened market risk. Management that is willing to reduce risk and lower profitability during periods of heightened market risk or challenging business conditions supports a risk tolerance assessment of "adequate" or higher. Management that takes on risk and is unwilling to accept lower profitability, or to slow organic or acquisitive growth, suggests an aggressive risk appetite and a lower risk position assessment. The higher a firm's risk tolerance, the less reliable even recent results or metrics (including static financial information used as a base case for our forecasted RAC) are as a measure of its future risk position and loss experience and, therefore, its capital adequacy.
154. We assess risk tolerance relative to national peers and those with similar anchors. We factor in our outlook for sector operating conditions and the broader market conditions. We also include in our assessment the firm's history of regulatory compliance, except fines that are factored into the loss experience assessment--so here we factor in any history of drawing additional attention from official government or regulatory agencies, including memorandums of understanding and orders to suspend activities.
155. To assess risk tolerance, we analyze management's stated return/risk objectives, limits, and growth relative to peers (such as trends in market volumes and portfolio holdings), along with:
- The frequency and scale of breaches of stated risk limits or standards (i.e., securities inventory aging, position losses [actual and stressed], customer credit, or margin rules or position limits);
  - The volatility of trading returns and VaR, particularly the gap between the highest observed VaR and average VaR in recent periods; and
  - Trends in risk relative to historical levels and peers with a similar anchor in an effort to increase revenue.
156. Examples of weaker risk tolerance include:
- Offering more bridge financings, underwriting more on a committed basis or otherwise committing the firm's capital and increasing direct exposure to investment banking clients;
  - Increasingly acting as principal in trades for clients as opposed to acting as an agent;
  - Displaying weakening credit underwriting standards relative to peers with a similar anchor; and

- Taking on riskier, more marginal clients or supporting riskier client activity.

## ii) Growth and changes in exposure

157. Our assessment of growth and changes in exposure focuses on the degree to which changes in S&P Global Ratings' RWAs may be indicative of a material change in risk appetite, versus a short-term change. A short-term slowing of growth or reduction in exposure may only be a response to a change in business environment and not represent a long-term change in risk appetite. Growth and changes in exposure is consistent with below "adequate" risk appetite when indicative of a material increase in risk exposure.
158. Growth and changes in exposure supports an "adequate" or higher risk appetite assessment when we observe that the firm's risk is decreasing materially over time relative to what is captured in the RACF.
159. Growth and changes in exposure supports a lower than "adequate" risk appetite assessment when rapid increases in prospective risk combine with insufficient management capacity to manage risks associated with a firm's growth and changes in exposure. Growth and changes in exposure would typically be assessed as weaker when a firm is displaying one or more of the following trends:
- Showing more aggressive recent organic or acquisitive growth and more significant prospects for future growth than in the past or compared with peers with a similar anchor;
  - Moving materially into new product, customer, or market activities outside of its traditional area of expertise; or
  - Increasing S&P Global Ratings' RWAs, VaR, trading assets, and trade and underwriting volumes, or decreasing its ratio of ACE to total managed assets relative to historical levels and peers'.
160. Indications of a stronger trend in risk exposures, which would support a risk appetite assessment of "adequate" or higher, include:
- Reducing or exiting risky activities (i.e., acting more as an agent for clients than as a principal in transactions);
  - Shrinking total exposure by reducing the amount or improving the quality of positions;
  - Remaining more focused on serving its core customer base with traditional expertise and limiting opportunistic proprietary activities;
  - Keeping to a similar portfolio of risks that limited losses in previous economic or market downturns; and
  - Decreasing S&P Global Ratings' RWAs, VaR, trading assets, and trade and underwriting volumes, or increasing its ratio of ACE to total managed assets relative to historical levels and peers', which is expected to continue.

## 3) Risk concentration

161. Risk concentration is risk position's third subfactor and can play an important role for securities firms, often contributing to securities firm defaults. We assess risk concentration as "positive," "neutral," or "negative" to risk position. In our experience, when appropriately managed, diversification of risks appears to lead to lower overall losses relative to less diverse peers. The

business position factor captures concentrations in revenue contribution by business line and uses concentrated earnings sources as an indicator of low-quality earnings. By contrast, this risk position subfactor focuses on the concentration of exposures to individual debtors, counterparties, and industries or sectors, or aggregations of risk across asset classes and risk types. Metrics used, where available, include large exposures versus capitalization (e.g., a firm's top 20 exposures relative to TAC and to regulatory capital at any regulated entities).

162. This subfactor strengthens risk position when:

- Geographic diversification arises from exposures that are clearly connected with a client franchise abroad and not from opportunistic product, tax, regulatory, or currency arbitrage; or
- Sector- or risk-type diversification arises from operations in activities that are no more risky than the firm's traditional core business.

163. The subfactor weakens risk position in each of the following situations:

- Risk exposures by sector, country, or single name in the loan portfolio, investment portfolio, and the trading book are more concentrated than for peers with a similar anchor and are not fully captured in the RACF adjustment. This may include material environmental exposures, including those from dealing in physical commodities that are exposed to significant climate transition risk, such as fossil fuels or environmentally damaging physical commodities; outside physical risk arising from accepting as collateral assets or properties with underlying exposure to floods or severe weather; or overexposure to an agricultural sector vulnerable to climate change or another sector that is likely to see an erosion of its credit quality because of disruption from customer or behavioral changes or changing environmental or social regulations.
- Derivatives, counterparty, or other trading partner exposure is material and concentrated across few trades and/or counterparties.
- Illiquid investments account for more than 125% of TAC.

#### **4) Complexity**

164. The final subfactor in our risk position assessment is complexity. We assess it as "neutral" or "negative" to risk position. Greater scale and diversification of business lines and geography may bring diversification benefits to a firm, but also increase complexity. An ever-increasing level of complexity in products, business lines, regions, and organizational structure may outpace a firm's capacity to manage risk. More complex products, such as derivatives, off-balance-sheet activities, securitizations, and other exotic products, have also, in our experience, led to greater complexity and increased risk. We do not give credit for diversification to those highly complex institutions that are most difficult to manage (for example, because of the potential for legal or regulatory risks or costly litigation arising from weaknesses in governance, risk appetite, or the control framework). Complexity can weaken, but does not strengthen, risk position, and does so to the extent it increases or obscures risks.

165. The opposite of complexity is represented by transparent and straightforward risks that are well-understood and well-managed compared with those of peers with a similar anchor.

166. Complexity weakens risk position to the extent that a firm has one or more of the following:

- A significant and above-peer amount of business is in complex products, such as derivatives, securitizations, and structured credit such as collateralized debt obligations.



- The transparency of a firm's underlying risk positions, risk management, earnings generation, or asset valuation is limited.
- A firm relies heavily on mathematical models and their underlying, often complex, assumptions to measure and manage risk and to value assets and liabilities.
- A firm is dependent on model-controlled or otherwise automated trading technology to execute a high volume of trades or as part of complex trading strategies.
- A portfolio contains a higher-than-peer level of risks with a low probability of occurrence but high-loss severity, otherwise known as tail risk.
- Balance sheet management involves unusual regulatory arbitrage.
- Operations are in many jurisdictions, or the organizational structure has many legal entities, which may stretch management's capacity to observe and address risk.

<sup>167.</sup> In addition to the qualitative elements in the previous paragraph, a quantitative indicator--a high ratio of total managed assets to ACE that is not mirrored in a low and declining RAC ratio--can indicate additional risk from complexity. The ratio of total managed assets to ACE is a measure of leverage, insensitive to risk and susceptible to definitional accounting inconsistencies. Nevertheless, high multiples may capture risk exposures that other metrics do not capture. In such cases, the risks, which weaken creditworthiness, likely are the result of off-balance-sheet activities or large derivative positions, implying complexity and opaque risks.

## **E. Funding And Liquidity**

### **Parent or group support**

<sup>168.</sup> For both fincos and securities firms, parent or group support--when ongoing, stable, and expected to continue--can lend strength to funding and liquidity that is assessed below "adequate." If an NBF's stand-alone funding assessment is "moderate" or "weak," or its liquidity assessment is "adequate-low," "moderate," or "weak" and its group status is "strategically important" or higher (as defined in "Group Rating Methodology"), then we could raise the funding assessment to "adequate" for both securities firms and fincos, and the liquidity assessment to "adequate" for fincos and "adequate-high" for securities firms (so that the combination is neutral to the SACP in tables 21 and 24) if all of the following characteristics are met:

- The parent is willing and has sufficient funding and liquidity to meet the firm's needs.
- The parent has a demonstrated history of providing funding and supporting the liquidity of its subsidiary, or has made a strong commitment to do so.
- There are no material regulatory or other barriers to the parent providing this support.
- The parent provides this support on an ongoing basis.

### **Finance Companies**

<sup>169.</sup> Funding and liquidity (the fourth SACP or GCP factor) assesses a finco's capacity to support business performance through effective funding while managing liquidity requirements both on an ongoing basis and in periods of stress. The analysis is guided by the basic principle that stable and long-term funding sources generally should finance long-term and less liquid assets, and that the

use of short-term wholesale funding finances generally should be limited to financing of short-term and more liquid assets.

170. We assess funding and liquidity in three steps. First, we analyze the stable funding ratio (SFR) and the liquidity coverage measure (LCM) to determine whether each is sufficient to support an initial assessment of "strong" for funding and liquidity, respectively. Second, we consider several qualitative and quantitative factors, including a cash flow forecast, to determine the assessments of funding and liquidity as well as to lower an initial assessment of "strong" if warranted. And third, we combine the two resulting assessments for funding and liquidity to determine their aggregate impact on the SACP or GCP (see table 21).

Table 21

**Combining A Finco's Funding And Liquidity Assessments To Determine The Impact On The SACP Or GCP**

--Funding--	--Liquidity*--			
	Strong	Adequate	Moderate	Weak
<b>Strong</b>	+1	0	-1 ('bb+' cap)	'b-' cap
<b>Adequate</b>	0	0	-1 ('bb+' cap)	'b-' cap
<b>Moderate</b>	0	-1	-2 ('bb+' cap)	'b-' cap
<b>Weak</b>	-1	-2	-3 ('bb+' cap)	'b-' cap

\*A liquidity assessment of "very weak" applies when the analysis indicates that liquidity sources are potentially insufficient to meet uses in the coming 12 months and, thus, a path to default has been identified due to a negative cash-flow forecast or other qualitative indicators in the liquidity assessment (see table 23), and as such, we would apply "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings," published Oct. 1, 2012.

**1) Funding**

171. Funding is assessed based on the SFR and 10 qualitative characteristics (see table 22). A finco's SFR is defined in "Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions," published July 17, 2013 (our "metrics criteria"). The SFR provides a holistic view of a finco's available stable funding (ASF) sources relative to its stable funding needs (SFN).
172. An SFR of 110% or higher is necessary to achieve a funding assessment of "strong." Most fincos do not have "strong" funding, especially relative to banks. SFRs are combined with a qualitative assessment to determine the funding assessment. If the SFR is less than 110%, a positive qualitative assessment can support a funding assessment of "adequate" or "moderate." Conversely, a negative qualitative assessment can shift the funding assessment down by one or more levels (for example, to "adequate" from "strong") even if the SFR exceeds 110%. The qualitative assessment includes an evaluation of the assumptions made in the SFR calculation as well as firm-specific funding strengths and weaknesses.
173. Since the assumptions made in the SFR do not vary by firm or country, the qualitative assessment is important and typically drives the assessment of funding for fincos when the SFR is below 110%.

Table 22

Funding Assessment For Fincos
<b>The following 10 characteristics support funding. We assess funding as “strong,” “adequate,” “moderate,” or “weak” based on which of these positive characteristics apply.</b>
<p>1. The majority of the company’s funding consists of stable deposits, government-provided debt, and/or well-staggered long-term or medium-term unsecured debt, and the company does not rely significantly on short-term debt.</p> <p>2. We believe the company could easily access multiple sources of secured and unsecured debt and/or deposits.</p> <p>3. If the company holds a significant portion of assets in a different currency than in the one it issues debt, it has reliable hedging (such as systems and processes) in place to manage and hedge its market risk. Also, the company is not heavily reliant on funding from foreign debtholders—or, if it is, that risk is already captured in the anchor.</p> <p>4. We believe the assumptions used to calculate the SFR accurately reflect the stability of the company’s funding relative to its assets and, as a result, do not materially overstate the SFR.</p> <p>5. If the company has significant deposit funding, most of the deposits are insured and are unlikely to be redeemed if the company came under significant stress.</p> <p>6. If the company has any significant maturity or single-creditor concentrations—either short-term or long-term—we are highly confident that those concentrations could not cause substantial refinancing risk at any point. We may have high confidence when the assets being financed are highly liquid and have low credit risk and/or the provider of the debt is a government-related entity or another strong and stable source with a close relationship to the company.</p> <p>7. The company is not exposed to significant risk from potential margin calls and could not lose access to significant amounts of funding in a short period because of a loss of debtholder confidence in the company.</p> <p>8. The company is not greatly reliant on debt sources that have proven highly unstable in the past—such as certain forms of debt secured by assets whose credit quality is not easily observed in the public markets (e.g., private-label mortgage or other types of complex off-balance-sheet funding).</p> <p>9. We do not expect a sharp increase in the company’s cost of funding that could substantially impair its earnings capacity.</p> <p>10. We do not expect the company to have difficulty retaining funding over the next year.</p>
<p><b>Strong</b></p> <ul style="list-style-type: none"> <li>• We expect the SFR to be 110% or higher and all 10 positive funding characteristics to apply.</li> </ul>
<p><b>Adequate</b></p> <ul style="list-style-type: none"> <li>• We expect the SFR to be 90% or higher, the positive funding characteristics numbered three to 10 to apply, and we do not consider funding “strong”; or</li> <li>• We expect the SFR to be below 90% and the positive funding characteristics numbered two to 10 apply.</li> </ul>
<p><b>Moderate</b></p> <ul style="list-style-type: none"> <li>• We expect the SFR to be below 90%, at least one of the positive funding characteristics numbered two to six does not apply, and the positive funding characteristics numbered seven to 10 do apply; or</li> <li>• We expect the SFR to be 90% or higher, but at least one of the positive characteristics numbered three to nine does not apply, and the last positive characteristic does apply.</li> </ul>
<p><b>Weak</b></p> <ul style="list-style-type: none"> <li>• We expect the SFR to be below 90%, and at least one of the positive characteristics numbered seven to 10 does not apply; or</li> <li>• We expect the SFR to be 90% or higher, and the last positive characteristic does not apply.</li> </ul>

## 2) Liquidity

<sup>174</sup> The liquidity assessment in most cases is based on a cash flow forecast and a qualitative assessment. In cases in which we are considering an assessment of “strong,” we would apply a

third assessment, the LCM. The LCM is the ratio of broad liquid assets plus available committed unsecured lines to short-term wholesale funding. We use the same definitions of broad liquid assets and short-term wholesale funding that we use for banks, as defined in the bank metrics criteria. While we count access to committed unsecured lines in the LCM, in the cash flow forecast we assess the likelihood that an NBFi would be able to draw on such lines under stress. A covenant violation or counterparty failure could restrict access. An LCM above 2x supports an assessment of "strong" when combined with cash flow forecasts and qualitative assessments supportive of "strong." An LCM of 1.5x-2.0x could also support a "strong" assessment when the analysis of qualitative and quantitative factors combined reveals material liquidity strengths that our metrics don't capture. We add the bank metric to ensure that any finco considered to have "strong" liquidity under these NBFi criteria would also be assessed as having "strong" liquidity if analyzed under our bank criteria.

175. However, an LCM above 1.5x-2x when combined with a cash flow or qualitative assessment not supportive of "strong" is not assessed "strong."
176. The cash flow forecast is calculated under a base case and stress case. The base case reflects our expectation for an issuer's cash flows over the next year, which could include any stresses that we anticipate over that period. The cash flow stress-case forecast incorporates a company-specific stress scenario. The stress scenario adopted is typically a low-probability (but still possible) scenario customized for the company. For instance, we assume an issuer typically would lose access to short-term (particularly unstable) funding sources in a stress scenario. We may make other assumptions, such as a rise in nonperforming assets, margin calls, and cash outflows from draws on any outstanding commitments. We would also assume that a portion of deposits may be unstable and could be redeemed. In addition, we will consider whether an issuer could borrow against or sell unencumbered assets--and at what conservative discount--and what cash inflows would likely result from loan amortization and cash earnings. Ultimately, debt stability, asset encumbrance, and asset amortization are key factors in the stress case. If a stress-case scenario includes a qualitative assessment (listed in paragraph 182), then it is not applied to the thresholds described in table 23 (i.e., the number of qualitative weaknesses associated with an incrementally lower qualitative assessment).
177. The qualitative assessment reveals no weaknesses if we believe that all of the following apply:
- 1) Liquidity management systems are appropriate to track cash inflows and outflows.
  - 2) There is effective liquidity stress-scenario management planning.
  - 3) There are no individual asset or liability concentrations that can compromise the firm's liquidity over a 12-month period.
  - 4) There is no potential for substantial, unexpected outflows that would strain liquidity resources (for example, contingent liabilities).
  - 5) Funding-based triggers. There are no contractual triggers that would compromise the company's ability to meet its liquidity needs over a 12-month period. One example is a collateral call in a margin agreement. Another example is when a facility repayment date can be accelerated upon failing a funding covenant or other similar test in transaction documents.
  - 6) There are no meaningful concerns with regard to reliance on bank funding, particularly in a stress scenario.
  - 7) Market signals (such as spikes in unsecured borrowing costs) do not suggest that the finco has restricted access to nonsecured funding from counterparties (banks).
  - 8) Liquidity-based triggers. We believe it is very unlikely that the company would have to quickly use liquidity resources to address any contractual triggers (for example, liquidity maintenance

covenants or contractual agreements) to an extent that would negatively affect overall liquidity.

- 9) Market signals do not indicate that the finco has noticeably weaker liquidity than other fincos (this differs from number seven in this list because it focuses on liquidity of assets and not cost of funding), such as increased price volatility of assets deemed highly liquid (such as short-duration highly rated government debt).
- 10) There are no large or unusual (i.e., large and exceeding normal asset flows) liquidity needs in the next 12-24 months.

Table 23

Liquidity Assessment For Fincos
<p><b>Strong</b></p> <p>All of the following apply:</p> <ul style="list-style-type: none"> <li>• We expect the LCM to be 2x or higher, or—if the analysis of qualitative and quantitative factors combined reveals material liquidity strengths that our metrics don't capture--1.5x-2.0x;</li> <li>• The cash flow forecast after applying stresses such as those indicated in the qualitative assessment (paragraph 177, items three to nine) reveals no weaknesses and indicates cash flow should cover funding needs in each month over the 12-month forecast period; and</li> <li>• The qualitative assessment (paragraph 177) does not reveal any weaknesses.</li> </ul>
<p><b>Adequate</b></p> <p>All of the following apply:</p> <ul style="list-style-type: none"> <li>• The cash flow forecast after applying stresses such as those indicated in the qualitative assessment (paragraph 177, items three to nine) indicates cash flow should cover funding needs in each month over the 12-month forecast period; and</li> <li>• The qualitative assessment (paragraph 177) does not reveal more than two weaknesses and does not place the cash flow forecast in doubt.</li> </ul>
<p><b>Moderate</b></p> <p>All of the following apply:</p> <ul style="list-style-type: none"> <li>• The cash flow forecast is positive under the base case;</li> <li>• After applying stresses such as those indicated in the qualitative assessment (paragraph 177, items three to nine), some uncertainties arise regarding the company's ability to cover its funding needs in one month over the 12-month forecast period;</li> <li>• The qualitative assessment (paragraph 177) reveals fewer than four weaknesses, none of which is items three, four, five, or six; and</li> <li>• No qualitative stress places the cash flow forecast in doubt.</li> </ul>
<p><b>Weak</b></p> <p>All of the following apply:</p> <ul style="list-style-type: none"> <li>• The cash flow forecast is positive under the base case;</li> <li>• After applying stresses such as those indicated in the qualitative assessment (paragraph 177, items three to nine), some uncertainties arise regarding the company's ability to cover its funding needs in more than one month over the 12-month forecast period;</li> <li>• The qualitative assessment (paragraph 177) reveals four or more weaknesses, and/or one or more of weaknesses three, four, five, or six apply; and</li> <li>• No qualitative stress places the cash flow forecast in doubt.</li> </ul>
<p><b>Very weak</b></p> <p>At least one of the following applies:</p> <ul style="list-style-type: none"> <li>• The cash flow forecast before applying stresses, such as those indicated in the qualitative assessment (paragraph 177, items three to nine), indicates cash flow will not cover funding needs in one or more month(s) over the 12-month forecast period;</li> <li>• The cash flow forecast after applying stresses, such as those indicated in the qualitative assessment (paragraph 177, items three to nine), reveals the failure to cover funding needs in the majority of month(s) over the 12-month forecast period; or</li> <li>• The qualitative assessment reveals sufficient weaknesses in either the firm's ability to cover funding in one or more month(s) over the 12-month forecast period, or raises sufficient doubt about the ability to rely upon the cash flow forecast.</li> </ul>

178. The base-case and stress-case cash flow forecasts are both forward-looking over the next 12 months. Base-case assumptions for sources of liquidity include: cash on hand and not already encumbered, unencumbered future cash inflows based on asset maturities, proceeds of any sale of liquid assets, and proceeds of any sale of receivables that have maintained liquidity through past economic cycles. Base-case assumptions for uses of liquidity include debt repayments at maturity and other payment obligations at maturity. The base case assumes undrawn committed bank lines are drawn upon to support the existing balance sheet and any forecasted growth.
179. The stress-case cash flow forecast includes entity-specific alternative scenarios that test the resilience of a finco's liquidity to certain plausible events. These events include: margin postings for borrowing agreements that require the finco to quickly and without warning expend resources to support the agreements or repay the borrowings; increases and decreases in the size of the balance sheet; calling of liquidity line borrowings; monetization of hedging gains and losses; and anticipated (and reasonably assured) inflows based upon proceeds from raising equity capital or outflows due to equity distributions (dividends). We determine the stress assumptions for these scenarios based on a combination of our view of management information and reporting, adverse effects of loan and funding concentrations, contingencies, past experiences, peer performances, and industry trends. If an assumption tested in our stress-case scenario overlaps with a weakness cited in our qualitative weaknesses listed in paragraph 177 (qualitative assessment), we do not double count. The weakness remains in the stress case and is not counted as a weakness when performing the qualitative assessment (see table 23).

## Securities Firms

180. For securities firms, we assess funding and liquidity separately and then combine them to determine the impact (in number of notches) on the SACP (see table 24). Funding and liquidity are closely related--liquidity's primary focus is short term, and funding's is longer term. When the funding and liquidity assessment identifies a path to default, the company typically meets the conditions in "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings," published Oct. 1, 2012.

Table 24

### Combining A Securities Firm's Funding And Liquidity Assessments To Determine The Impact On The SACP Or GCP

--Funding--	--Liquidity--				
	Strong	Adequate-High	Adequate-Low	Moderate	Weak
<b>Very strong</b>	+2	+1	0	-1 ('bb+' cap)	'b-' cap
<b>Strong</b>	+1	0	0	-1 ('bb+' cap)	'b-' cap
<b>Adequate</b>	0	0	-1	-2 ('bb+' cap)	'b-' cap
<b>Moderate</b>	0	-1	-2	-3 ('b+' cap)	'b-' cap
<b>Weak</b>	-1	-2	-3 ('bb+' cap)	-4 ('b-' cap)	'b-' cap

181. The gross stable funding ratio (GSFR) is funding's key metric, and liquidity's key metric is the LCM (see tables 25-27). Together they address both sides of funding risk: rollover risk of maturing funding and refinancing risk of less liquid assets. The GSFR measures the extent to which a firm uses stable funding to finance its less liquid or higher-risk assets. Long-term or illiquid assets funded by short-term, less stable funding sources expose a firm to greater funding risk. The LCM measures a firm's ability to manage its liquidity needs and reflects our expectation of forward liquidity needs relative to available liquidity, and we assess it by comparing sources and potential

uses. Both of these ratios are also placed into context by qualitative assessments.

182. Funding and liquidity assesses:

- Material risks stemming from the use of/reliance on collateralized funding (see paragraph 183);
- Material funding and liquidity risk related to currency mismatches;
- Data quality, including whether disclosures are adequate relative to the complexity of a firm's funding and liquidity risk; and
- A firm's position relative to any regulatory funding or liquidity requirements or standards.

183. Excessive reliance on collateralized funding sources, particularly short-term funding sources, like repo, can introduce risks not factored into the GSFR or the LCMs. We address this as follows:

- Asset encumbrance (see Glossary) is assessed qualitatively in the funding assessment when sufficient to constrain funding flexibility, and
- The need to meet margin calls or collateral calls to keep the funding outstanding, and the risk of not being able to roll this funding over on any economic terms is addressed in the liquidity assessment.

Table 25

**Funding And Liquidity Key Metrics For Securities Firms: The GSFR And The LCM**

Metric	Definitions
<b>Funding key metric</b>	
Gross stable funding ratio (GSFR)	Available stable funding/gross stable funding needs
Available stable funding	The sum of total equity net of intangibles, customer deposits, and long-term interbank and debt market funding, including hybrid instruments with no equity content maturing after one year
Gross stable funding needs	Customer loans, short-term reverse repurchase agreements and securities borrowing with customers maturing within one year net of haircut, long-term interbank loans receivable and reverse repurchase agreements and securities borrowing maturing after one year, securities holdings net of haircut, restricted cash (not excluding amounts segregated for customers), receivables from customers, brokers, and clearing organizations net of haircuts, all other non-insurance-company related or otherwise excluded assets, and off-balance-sheet credit equivalents net of haircut
<b>Liquidity key metric</b>	
Liquidity coverage metric (LCM)	Balance sheet liquidity sources divided by balance sheet liquidity needs (see below)
Balance sheet liquidity sources	Broad liquid assets excluding segregated assets plus available committed unsecured lines net of haircut
Balance sheet liquidity needs	Short-term wholesale funding plus payables to customers, brokers and clearing organizations net of haircut, off-balance-sheet commitments net of haircut
Broad liquid assets	Unrestricted cash, short-term interbank loans and reverse repurchase agreements and securities borrowing with banks maturing within one year, short-term reverse repurchase agreements and securities borrowing with nonbanks net of haircut maturing within one year, and securities holdings net of haircut

Note: See the Glossary for more detail on available stable funding and Appendix B for more detail on haircuts assumed in the funding and liquidity calculations for securities firms.



## 1) Funding

184. Funding assesses the strength and stability of a securities firm's funding mix relative to its funding needs, chiefly the risk and liquidity of its assets. We consider funding "appropriate" if a firm uses stable and long-term funding sources to refinance assets that potentially cannot be sold or reduced easily or without material costs or reputational damage in times of stress.
185. The assessment considers a firm's exposure to refinancing risk and other factors that affect its capacity to maintain funding of its assets under stressed conditions. Well-matched asset maturities and funding repayment dates strengthen the funding assessment by reducing exposure to potential funding gaps. In addition, excess stable funding can create liquidity buffers, which supports the funding and liquidity assessment.
186. We expect to assess funding as "very strong" only when a firm demonstrates an exceptional funding profile through having a GSFR of greater than 120% as well as direct access to central bank funding, low reliance on wholesale or short-term funding, and no material risk from funding concentrations.

Table 26

Funding Assessments For Securities Firms		
Score	What it means	Guidance
<b>Very strong</b>	Reflects our view that there is very strong excess sources of stable funding coverage, demonstrated by excess capacity of stable funding sources relative to needs given the firm's assets, businesses, and markets. Funding risk is limited by the presence of these considerable excess sources, by high-quality stable funding, and by access to central bank funding.	<p>Conditions 3 and either 1 or 2 are met:</p> <ol style="list-style-type: none"> <li>1. The firm has very strong levels of excess stable funding relative to stable funding needs given the firm's assets and markets, typically indicated by a GSFR expected to be above 120%.</li> <li>2. Additional sources of high-quality stable funding or additional asset liquidity not reflected in the GSFR's standard assumptions provide similar coverage of funding needs, including from OTC derivatives business.</li> <li>3. Any indications of additional funding risk in the qualitative assessment not captured in the GFSR are more than offset by excess capacity of high-quality stable funding or access to external dependable stable funding sources (including the central bank), or both, when combined, and no material unhedged funding currency mismatches exist.</li> </ol>
<b>Strong</b>	Reflects our view that there is strong excess capacity of stable long-term funding sources relative to needs given the firm's assets, businesses, and markets.	<p>Conditions 3 and either 1 or 2 are met:</p> <ol style="list-style-type: none"> <li>1. The firm has strong levels of excess stable funding relative to stable funding needs, typically indicated by a GSFR that is expected to be 110% or higher.</li> <li>2. Additional sources of high-quality stable funding or additional asset liquidity not reflected in the GSFR's standard assumptions provide similar coverage of funding needs, including from OTC derivatives business.</li> <li>3. Any indications of additional funding risk are more than offset by excess capacity of high-quality stable funding or access to external dependable stable funding sources, and no material unhedged funding currency mismatches exist.</li> </ol>
<b>Adequate</b>	Reflects our view that there is adequate capacity of stable, long-term funding sources relative to needs given the firm's assets, businesses, and markets.	<p>Conditions 4 and one of 1, 2, or 3 are met:</p> <ol style="list-style-type: none"> <li>1. The firm has adequate levels of excess stable funding relative to stable funding needs, typically indicated by a GSFR that is expected to be 90%-110%.</li> <li>2. Additional sources of high-quality stable funding or additional asset liquidity not reflected in GSFR's standard assumptions provide similar coverage of funding needs, including from OTC derivatives business.</li> <li>3. We expect a GSFR of 110% or higher, and, if we detect additional funding risks, they do not suggest an understatement of funding needs or an overstatement of funding sources, and no material unhedged funding currency mismatches exist.</li> <li>4. Any indications of additional funding risk are offset by excess capacity of high-quality stable funding or access to external dependable stable funding sources.</li> </ol>

Table 26 (continued)

Funding Assessments For Securities Firms		
Score	What it means	Guidance
<b>Moderate</b>	Moderate capacity of stable funding reflects our view that the company may fund a modest amount of long-term illiquid assets with less stable funding sources.	<p>One of the following three conditions is met:</p> <ol style="list-style-type: none"> <li>1. The firm has a moderate level of stable funding sources relative to stable funding needs, usually as indicated by: a GSFR near 90%; or quantifiable sources of high-quality stable funding; or additional asset liquidity, not reflected in the GSFR's standard assumptions, that provides a similar coverage of funding needs. And any additional funding strengths are more than offset by indications of additional funding risks.</li> <li>2. We expect a GSFR of 90%-110%, or even above 110%, but we detect weaknesses such as (i) GSFR standard assumptions that overstate funding stability or understate stable funding needs; or (ii) the presence within the firm of large prime brokerage or OTC derivatives businesses, which, in combination with a lack of central bank access, weakens funding stability; or (iii) material funding concentrations.</li> <li>3. The firm may become, but is not yet, reliant on central bank funding to meet its ongoing funding needs, and it has access to central bank funding.</li> </ol>
<b>Weak</b>	Reflects our view that a firm's funding risk is excessive because it funds a large portion of long-term illiquid assets with less stable sources, which raises the potential for funding gaps.	<p>One of the following three conditions is met:</p> <ol style="list-style-type: none"> <li>1. The firm's funding risks or needs are outside relative to its sources of stable funding, which raises the risk of funding gaps.</li> <li>2. The firm has a weak level of stable funding relative to stable funding needs, usually indicated by (i) a GSFR of less than 90%, or (ii) by quantifiable sources of high-quality stable funding, or (iii) by weaker asset liquidity not reflected in the GSFR's standard assumptions providing a similar coverage of funding needs.</li> <li>3. A GSFR of moderate (90%–110%) or stronger (above 110%), but the scale or scope of additional risks substantially outweighs strengths sufficient to make 1 apply.</li> </ol>

187. In addition to the GSFR and those considerations stated in paragraphs 182 and 183, the funding qualitative assessment considers three indicators:

- The appropriateness of GSFR standard assumptions for the particular firm;
- The quality of stable funding, including concentrations; and
- Funding currency mismatch risk.

188. The GSFR standard assumptions are supportive of the funding assessment indicated by the calculation when they do not understate SFN or overstate the amount or stability of stable funding. Specifically, the GSFR standard assumptions typically support the funding assessment when the haircuts used to assess SFN accurately reflect a firm's quality and liquidity of assets and raise the assessment if the firm's assets are materially more liquid than the standard assumptions. It could lower the funding assessment, typically by one level lower than that derived

from the GSFR, if a firm's assets are materially less liquid than the standard assumptions, or if it has significant SFN not captured in the GSFR, including material contractual investments or funding commitments (i.e., intraperiod investment banking commitments like bridge loans underwriting securities on a committed basis) or large over-the-counter (OTC) derivatives businesses, unless it has sufficient excess stable funding or access to external stable funding to meet these needs.

189. The quality of stable funding is supportive of the funding assessment derived from the GSFR when:
- The deposit franchise and mix is not materially weaker or more confidence sensitive than peers. Deposits included in stable funding are stable customer deposits. We typically exclude other banks' short-term deposits and wholesale and Internet deposits with maturities shorter than one year;
  - If the firm can pledge or otherwise use brokerage customer assets to fund customer activity, brokerage customer balances are predominantly retail or otherwise stable and not more confidence sensitive than peers; and
  - There is no material additional risk from large funding concentrations as measured by: source (i.e., number of providers) or tenor (i.e., maturity concentration); funding tools (e.g., dependence on secured funding such as covered bonds, repo, central bank funding, or securitization or use of confidence-sensitive funding such as commercial paper, bank deposits, or short-term notes that could reduce funding flexibility); and the firm's funding needs relative to the markets in which it operates.
190. When the analysis of the funding qualitative indicators analytical factors combined reveals material funding strengths that our metrics cannot capture (i.e., the GSFR overstates refinancing risk), the funding assessment can be higher than that indicated by the GSFR--though we do not expect this would happen often. This may be the case if, for example, a firm conducts reverse repo and repo transactions only with the highest-quality collateral and its book is fully matched in terms of tenor.
191. Funding currency risk is not supportive of the funding assessment when a firm has material unhedged foreign currency mismatches or when reliance on foreign funding (net external assets or liabilities) is more material than reflected in its anchor.
192. Some securities firms benefit from ongoing direct access to funding from central banks. The presence of this backstop supports an "adequate" or higher funding assessment only until the point at which it appears necessary to be utilized. At that point, we would lower the funding assessment to "moderate" or lower because the strength of having access to such funding would be offset by a weakness given an ongoing or potential dependence on such funding to remain a going concern.

## **2) Liquidity**

193. The liquidity analysis centers on a securities firm's ability to manage its liquidity needs in adverse market and economic conditions and its likelihood of survival over an extended period in such conditions. We assess it by comparing sources and potential uses (see table 27).
194. Securities firms typically enter into financial contracts in which margin (or collateral) is posted in favor of the securities firm or its counterparty. They also enter into contracts in which investors are promised asset value stability. For example, a securities firm purchases an asset through repo, and then re-hypothecates the asset by selling it, but offers to sell it back to the original

counterparty at the original price. This situation leaves the securities firm exposed to market risk if the asset price changes prior to re-purchasing the asset in order to fulfill its obligation to the first counterparty. These financings make it difficult to reliably measure the likelihood and scale of all potential stressed liquidity needs. The more likely and substantial the impact of a reduction in the availability or economics of a firm's funding sources, the more back-up liquid resources are needed to offset this risk. The liquidity analysis includes assessing the potential liquidity demands relative to liquidity sources:

- On-balance-sheet liquidity, including the LCM, the appropriateness of LCM standard assumptions for the particular firm, and dependence on central bank borrowing, and
- Management of off-balance-sheet and stressed liquidity risks, including the scope and complexity of contingent liquidity needs and contingent liquidity demands and margin or collateral calls relative to unencumbered liquidity.

195. Access to central bank borrowing is supportive of the assessment when a firm is either not using it or has demonstrated it is not dependent on it. Dependence on central bank borrowing lowers the liquidity assessment, typically to "weak."

196. The LCM standard assumptions are supportive of the assessment when they do not understate short-term liability outflows or overstate asset liquidity. When our analysis reveals material liquidity weaknesses or strengths that our metrics cannot capture, the liquidity assessment can be higher or lower. When the haircuts used to assess the liquidity of securities or other financial assets materially understate the asset's liquidity and do not understate the firm's liquidity demands, the assessment can be raised above that indicated by the LCM. Conversely, if the LCM standard assumptions overstate the liquidity of a firm's assets or understate the firm's potential liquidity demands, it would typically lower the liquidity assessment below that derived from the LCM.

197. For example, the liquidity assessment can be stronger when the LCM overstates liquidity risk, contingent liquidity risks are well covered, and market indicators do not suggest to us that creditors' and/or shareholders' confidence in the firm has declined. An example where the LCM may overstate liquidity risk is a firm whose assets almost entirely comprise very low risk, very highly rated asset-backed securities (ABS) in a country where these are traded actively, such as U.S. student loans or credit card receivables, which may be more liquid than the 100% haircut used to calculate the LCM.

198. The scope and complexity of off-balance-sheet contingent liquidity demands are supportive of the liquidity assessment when all of the following apply:

- The firm has either no material OTC derivatives or prime brokerage businesses, or it has sufficient excess liquidity or access to external liquidity to cover these businesses.
- The firm maintains buffers of high-quality liquidity (such as cash, unencumbered highest-quality securities, and committed available funding lines) that exceed collateral and margin calls and other stress liquidity needs.
- Liquidity risk of customer confidence sensitivity is not material because a firm does not have material exposure to more confidence-sensitive customers, or its conservative collateral management or significant excess liquidity limits this risk.

199. Material barriers to the movement of liquidity across a firm's entities are not supportive of stronger liquidity and typically lower the liquidity assessment. However, the qualitative assessment can support a stronger liquidity assessment when material mismatches are not prevalent at individual group members or there are no material impediments to cross-member

liquidity movement. If a firm's operations are conducted out of regulated subsidiaries, regulators are not expected to interfere with normal or necessary cross-member funding or liquidity flows. The firm or its regulated entities are not under financial stress that appears likely to significantly increase the likelihood of regulatory interference. The assessment, in particular, considers limitations on fungibility for entities that we consider "insulated subsidiaries" under our "Group Rating Methodology."

**Table 27**

<b>Liquidity Assessments For Securities Firms</b>		
<b>Score</b>	<b>What it means</b>	<b>Guidance</b>
<b>Strong</b>	Reflects our view that a firm is well prepared to meet liquidity demands under stressful market conditions for at least 12 months.	<p>All of the following conditions are met:</p> <ul style="list-style-type: none"> <li>• The firm has considerable excess capacity to meet potential stressed liquidity needs for more than 12 months, typically indicated by an LCM expected to be above 1.5x;</li> <li>• Potential for margin or collateral calls, liquidity mismatches, barriers to fungibility or concentrations are modest in scope and size relative to excess liquidity;</li> <li>• Assets are at least as liquid and any funding from brokerage customer payables and bank deposits and other stable funding sources are at least as stable as assumed in the LCM;</li> <li>• If the firm has OTC derivative, prime brokerage business, or otherwise potentially material or complex contingent off-balance-sheet liquidity demands, these are modest relative to available sources of liquidity (including excess LCM sources minus any GSFR deficit, and external sources including from a central bank); and</li> <li>• Customer asset protection and collateral management do not represent material additional risk.</li> </ul>
<b>Adequate-High</b>	Reflects our view that a firm should have capacity to meet its needs under stressful market conditions for at least 12 months.	<p>One of the following three conditions is met:</p> <p>The LCM indicates that the firm has excess capacity to meet potential stressed liquidity needs for more than 12 months, typically indicated by an LCM expected to be between 1x and 1.5x and additional liquidity risk is modest;</p> <p>The LCM supports a "moderate" or an "adequate-low" assessment, but additional sources of liquidity not captured in the LCM, particularly access to a central bank, more than offset indications of liquidity risk; or</p> <p>The LCM supports a "strong" assessment, but indications of additional liquidity risk or demands not captured in the LCM considerations are negative for the liquidity assessment and lower the final assessment. Liquidity ratios and market indicators do not identify the company as an outlier.</p>

Table 27 (continued)

Liquidity Assessments For Securities Firms		
Score	What it means	Guidance
<b>Adequate-Low</b>	Reflects our view that a firm will meet its liquidity demands under moderate market stress for the next 12 months, but more severe or prolonged stressful market conditions may be a challenge.	<p>One of the following three conditions is met:</p> <ul style="list-style-type: none"> <li>• We expect the firm to meet liquidity demands even under stress, but its capacity to meet more severe stressed liquidity demands could be strained, usually as indicated by an LCM between 0.9x and 1x;</li> <li>• Although the LCM is indicative of "strong" coverage, "adequate-low" is assessed when a combination of weaknesses, including two or more of the following, are present and are not offset by strengths that would enable an "adequate-high" assessment: higher brokerage or deposit customer sensitivity, potential for barriers to fungibility of group resources, indications that asset liquidity is substantially weaker than standard assumptions, excessive asset encumbrance, or other indications of more liquidity risk; or</li> <li>• The LCM indicates "adequate-high" coverage but a combination of barriers to the movement of capital and liquidity, asset encumbrance, funding concentrations or weakness in the qualitative assessment are indicative of additional liquidity risk but not so severe as to suggest liquidity is less than adequate.</li> </ul>
<b>Moderate</b>	Reflects our view that a firm will meet its liquidity demands under normal market conditions over the next 12 months, but is vulnerable to moderate or prolonged market or other stress.	<p>One of the following two conditions is met:</p> <ul style="list-style-type: none"> <li>• The company could be challenged to meet its liquidity demands under adverse conditions for the next 12 months, as indicated by the LCM expected to be below 0.9x and additional indications of liquidity risk not captured in an LCM; or</li> <li>• The LCM indicates "adequate-high" coverage but substantial or complex off-balance-sheet liquidity demands or other additional liquidity risk likely leaves the firm's liquidity more exposed to moderate stress.</li> </ul>
<b>Weak</b>	Reflects our view that a firm's liquidity is vulnerable under expected conditions or is highly dependent on official liquidity support, which is available but may be finite.	<p>One of the following two conditions is met:</p> <ul style="list-style-type: none"> <li>• The firm has no access to unsecured debt capital markets. For refinancing, the securities firm has access to and relies on government or central bank liquidity facilities, and it is not clear that the securities firm can fund independently in the market in the next six months. The liquidity support from central banks or governments is currently available but support may be finite; or</li> <li>• We expect the company to be challenged to meet its liquidity demands over the next 12 months, as indicated by an LCM expected to be below 0.9x and additional indications of substantial liquidity risk not captured in the LCM. However, a pathway to default has not yet been identified.</li> </ul>

## F. Comparable Ratings Adjustment

<sup>200</sup> After considering all of the other entity-specific factors, we then may adjust the SACP or unsupported GCP up or down one notch, or leave it unchanged, based on our comparable ratings analysis. This analysis is a holistic review of a company's stand-alone credit risk, in which we evaluate its credit characteristics in aggregate. A positive assessment leads to a one-notch higher SACP or unsupported GCP, a negative assessment leads to a one-notch lower SACP or

unsupported GCP, and a neutral assessment indicates no change to the SACP or unsupported GCP.

201. Generally, we compare an entity with all other entities in the same sector and country of domicile. More specifically, the peer group is typically NBFIs that are in the same sector and have similar SACPs or unsupported GCPs (i.e., the same or one notch higher or lower). However, the peer groups may include others. For example:
- The peer group may include banks in the same country when the SACP or unsupported GCP is close to the bank anchor.
  - The peer group may include NBFIs in the same sector but in different countries if there's an insufficient number of domestic peers or because regional or global peers form a better comparison.
  - The peer group may include NBFIs from other sectors when the entity's business overlaps with or is adjacent to other NBFI sectors (for example, a finco that executes cash and collateral business similar to securities firms).

### **III. External Influence And Sovereign Rating Limitations**

202. After determining the SACP or unsupported GCP, we then factor in any potential external influences on an NBFI to determine the ICR. These could include group or government influence, guarantees, or the application of the rating above the sovereign criteria.

#### **A. Group Influence**

203. We continue to factor any group influence into our ratings on NBFIs by applying "Group Rating Methodology." This methodology explains how our assessment of likely extraordinary group or parent company support (or, conversely, negative group intervention) factors into the ICR on an entity that is a member of a group.

#### **B. Government Influence**

204. Certain issuers that we rate under these criteria are GREs, which are enterprises potentially affected by extraordinary government intervention during periods of stress. GREs are often partially or totally controlled by a government (or governments), and they contribute to implementing policies or delivering key services to the population (see paragraph 3 of "Rating Government-Related Entities: Methodology And Assumptions" for more). We apply these criteria to NBFIs that we classify as GREs to determine their SACPs. The GRE criteria explain how our assessment of likely extraordinary government support (or, conversely, negative government intervention) factors into the ICR on an entity. For NBFIs that are not GREs, but are declared systemically important financial institutions by regulators, these criteria factor in the likelihood of the firms receiving extraordinary support from a government by applying chart 4 and paragraphs 162-205 in "Banks: Rating Methodology And Assumptions." Typically, in our experience, few NBFIs are beneficiaries of extraordinary government support.



## C. Guarantees Or Other External Influence

205. We also continue to factor in guarantees supporting an NBFIs creditworthiness. If an NBFIs has guarantees on all of its financial obligations and if the guarantees meet the criteria in "Guarantee Criteria," published Oct. 21, 2016, the rating on the NBFIs would be either the ICR on the guarantor or the ICR implied by these criteria, whichever is higher.

## D. Rating Above The Sovereign

206. Finally, although unlikely, if we rate an NBFIs higher than the sovereign in which the NBFIs is domiciled, we apply "Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions," published Nov. 19, 2013, to determine the maximum number of notches that the NBFIs is rated above the sovereign.

## APPENDIX

### A. Calibration Of The Ratings

207. We calibrate our NBFIs ratings criteria based on our analysis of the history of defaults, the impact of various financial and economic crises on NBFIs creditworthiness, the credit strength of the NBFIs sectors compared with other sectors, and our framework for the behavior of our credit ratings over time through economic cycles. We outline our framework in two articles: "S&P Global Ratings Definitions," published Aug. 7, 2020, and "The Time Dimension Of Standard & Poor's Credit Ratings," published Sept. 22, 2010.
208. NBFIs are typically unregulated or lightly regulated, and, in general, the absence of a regulatory framework is reflected in the default and transition statistics, which show higher ratings and higher stability for banks relative to NBFIs (see "2012 Annual Global Financial Institutions Default And Rating Transition Study," published July 25, 2013).
209. Consequently, although S&P Global Ratings' NBFIs ICRs can span the entire rating scale, a large proportion of ratings are 'BBB' or lower. Of NBFIs ratings, approximately two-thirds are currently 'BBB-' or higher (including public and confidential ratings). Of those, approximately one-fourth are in the 'A' category, just over one-third are in the 'BBB' category, and just under one-tenth in the 'AA' category, for nonbank financial issuers. Our rated universe is very concentrated in developed countries and midsize to large NBFIs, and it is likely that many of the unrated NBFIs would fall in the 'B' or 'CCC' rating categories.
210. The main sources that we have used to review the history of financial institutions defaults are S&P Global Ratings' default studies (see "2012 Annual Global Financial Institutions Default And Rating Transition Study," published July 25, 2013, which covers the performance of S&P Global Ratings' financial institutions ratings, both in terms of transition and default, over 1981-2012). The study covers banks and nonbanks. Default rates increased during periods of economic stress, such as economic downturns, or following major catastrophes, but have remained relatively low. The study indicates that NBFIs diverge from banks in terms of ratings profile. Globally, the median rating for nonbanks has consistently been a notch or two lower than the median bank rating since the early 1990s, but the gap closed in 2012.
211. Our criteria are informed by several periods of heightened stress that resulted in the defaults of some NBFIs. Our default study notes nonbank defaults stretching back as early as 1982. A number

of fincos defaulted in the U.S. during the same period of macroeconomic stress in the U.S. in which savings and loan banks defaulted, and again during the period of increased defaults of mortgages, some required government funding support during the financial crisis of 2007-2009. For securities firms, in 2011, MF Global defaulted rapidly after it lost confidence of counterparties and funding sources.

212. The criteria globally address the issues that caused these defaults, including introducing new liquidity and capital metrics, incorporating our analysis of the macro-environment (through the anchor, which is the starting point for assigning a rating), and reducing the emphasis on earnings in our analysis for all NBFIs.

## B. Haircuts For Securities Firms' Funding And Liquidity Calculations

Table 28

### Haircuts For Securities Firms--Gross Stable Funding Ratio

(B) Available stable funding / (A) gross stable funding needs

Line item	Haircuts (%)
<b>A. Gross stable funding needs = total of:</b>	
Unrestricted cash	0
Reverse repo with financial institutions maturing in less than one year	0
Reverse repo with financial institutions maturing in more than one year	100
Reverse repo with customers maturing in more than one year	100
Reverse repo with customers maturing in less than one year	50
Receivables from brokers and clearing organizations	10
Receivables from brokerage customers (including margin loans)	10
Loans to banks maturing within one year	0
Loans to banks maturing in more than one year	100
Customer loans (net) - all maturities (other than margin loans)	100
Derivative assets	0
Insurance assets and excluded consolidated variable interest entities	0
Intangibles	0
All "other assets" (fixed, illiquid assets, like property plant and equipment, etc.)	100
Off-balance-sheet commitments, guarantees, letters of credit	5
<b>Illiquid portion of securities owned (unencumbered and encumbered):</b>	
Home sovereign and government agency debt	0
Subsovereign government	0
Certificate of deposit/commercial paper	0
Foreign government	0
Government-sponsored mortgage-backed securities (MBS), policy banks	0
Covered bonds, excluding own covered bonds	0
Bank debt	50
Corporate debt	50

Table 28

**Haircuts For Securities Firms--Gross Stable Funding Ratio (cont.)**

**(B) Available stable funding / (A) gross stable funding needs**

Line item	Haircuts (%)
MBS other and mutual funds	50
Other debt securities	50
Equities and gold	50
Loans	100
Asset-backed securities (other than MBS)	100
Commodities (exclude gold if disclosed)	100
Other (e.g., not listed equities)	100
<b>B. Available stable funding = total of:</b>	
Customer deposits - all maturities	100
Deposits of other banks maturing in less than one year	0
Deposits of other banks maturing in more than one year	100
Payables to brokers/dealers and clearing organizations	0
Brokerage clients payable	0
Repurchase agreements - all maturities	0
Nonderivative trading liabilities (e.g., short positions)	0
Derivative liabilities	0
Debt, hybrids, and minority interest, with puts or maturing in less than one year	0
Debt issued maturing above one year	100
Total equity net of intangibles	100

Table 29

**Haircuts For Securities Firms--Liquidity Coverage Metric**

**(C) Available liquidity / (D) balance sheet liquidity needs**

Line item	Advance rates (%)
<b>C. Available liquidity = total of:</b>	
Unrestricted cash	100
Loans to banks (net) maturing within one year	100
Reverse repo with financial institutions maturing in less than one year	100
Reverse repo with customers maturing in less than one year	50
Accessible capacity of committed credit lines maturing in more than a year	75
<b>Liquid portion of securities owned (unencumbered and encumbered):</b>	
Home sovereign and government agencies	100
Subsovereign government	100
Certificate of deposit/commercial paper	100
Foreign government	100

Table 29

**Haircuts For Securities Firms--Liquidity Coverage Metric (cont.)****(C) Available liquidity / (D) balance sheet liquidity needs**

<b>Line item</b>	<b>Advance rates (%)</b>
Government-sponsored mortgage-backed securities (MBS), policy banks' debt	100
Covered bonds, excluding own covered bonds	100
Bank debt	50
Corporate debt	50
MBS other and mutual funds	50
Other debt securities	50
Equities and gold	50
Loans	0
Asset-backed securities (other than MBS)	0
Commodities (excluding gold if disclosed)	0
Other (e.g., equity stakes; not listed equities)	0
<b>D. Balance sheet liquidity needs = total of:</b>	
Customer deposits - all maturities	0
Other banks' deposits maturing in less than one year	100
Other banks' deposits maturing in more than one year	0
Payables to brokers/dealers and clearing organizations	5
Brokerage clients payable	5
Short-term debt and debt maturing within one year	100
Repurchase agreements - all maturities	100
Acceptances	100
Nonderivative trading liabilities (e.g., short positions)	100
Derivative liabilities	0
Debt and other capital with puts or maturing in less than one year	100
Off-balance-sheet commitments, guarantees, and letters of credit	5

**C. Glossary**

**Adjusted assets.** Assets as reported, less insurance statutory funds, nonservicing intangibles, and allowance for loan losses in countries where such reserves are represented as a liability account.

**Adjusted common equity.** Common equity and equity minority interests minus revaluation reserves, goodwill, other nonservicing intangibles, interest-only strips (tax effected), and tax loss carryforwards, or other deferred taxes not permitted by regulators, plus or minus any other equity adjustments.

**Adjusted total equity.** Total adjusted capital plus reserves deemed to be general or unallocated, plus unrealized gains, less equity in unconsolidated subsidiaries, less any adjustments for securitized assets.

**Asset encumbrance.** Assets are encumbered when contractually allocated or legally secured to specific funding issues or other repayment obligations. When assets are encumbered, they are not available to help repay unsecured debt or other repayment obligations, until the secured debt has been repaid.

**Available stable funding (ASF).** The sum of total equity net of intangibles, customer deposits, and long-term interbank and debt market funding, including hybrid instruments with minimal equity content maturing after one year.

**Average adjusted assets.** The average of the prior and current periods' adjusted assets.

**Broad liquid assets.** The sum of unrestricted cash, short-term interbank loans and reverse repurchase agreements and securities borrowing with banks maturing within one year, short-term reverse repurchase agreements and securities borrowing with nonbanks net of haircut maturing within one year, and securities holdings net of haircut. For haircuts, see Appendix B.

**Confidence sensitivity.** A qualitative assessment of an entity's sensitivity or vulnerability to an erosion of market confidence. Some entities are more vulnerable to market confidence than others because of their business models or funding mix.

**Core earnings.** Net income (before noncontrolling interest) (-) nonrecurring/special income (+) nonrecurring/special expense (+) goodwill and M&A-related intangibles impairment or amortization (+) allocation to funds for general banking risk (-) distributions due on all equity hybrid instruments accounted for as equity (+/-) other adjustments (+/-) tax impact of all adjustments above.

**Double leverage.** Calculated as holding company investments in subsidiaries divided by holding company (unconsolidated) shareholders' equity. Double leverage renders the nonoperating holding company (NOHC) dependent, in part, on dividends to meet interest payments on external debt.

**Earnings buffer for securities firms.** A metric that measures the capacity of earnings to absorb "normalized losses" through the credit cycle. The earnings buffer is calculated as core earnings plus the three-year average of provisions minus normalized losses, all divided by the expected RAC's RWAs. Normalized credit losses are defined as per the RAC framework.

**EBITDA.** Earnings before interest, taxes, depreciation, and amortization.

**Economic risk.** One of the two main analytical components (alongside industry risk) that determines our Banking Industry Country Risk Assessments (BICRA), designed to evaluate and compare global banking systems. We use the BICRA in setting the anchor--the first step in determining an NBFi rating. The economic risk of a banking sector is determined by the structure and stability of the country's economy, along with the central government's macroeconomic policy flexibility, actual or potential imbalances in the economy, and the credit risk of economic participants--mainly households and enterprises.

**Expected RAC ratio.** The primary capital metric for securities firms, it is a measure of prospective risk-adjusted capital adequacy using the RACF. The expected RAC ratio reflects our estimation of TAC and RWA over the RACF time horizon. The exposures and TAC used are based on recent complete financial or regulatory reporting, updated for new information and revisions to our estimations of components of TAC or the exposure inputs used to calculate RWAs. Estimated TAC does not include forecasted earnings, so dividends are only deducted if we expect them to be in excess of earnings.

**Financial flexibility.** A qualitative assessment of an entity's capital that contributes to our overall assessment of capital, leverage, and earnings. The assessment of financial flexibility considers an entity's ability to retain capital, reallocate capital between subsidiaries, and raise new capital, among other factors.

**Government-related entity (GRE).** Enterprises potentially affected by extraordinary government intervention during periods of stress. GREs are often partially or totally controlled by a government (or governments), and they contribute to implementing policies or delivering key services to the population. However, some entities with little or no government ownership might also be considered GREs, if we believe that they might benefit from extraordinary government support due to their systemic importance or their critical role as providers of crucial goods and services.

**Gross stable funding needs.** This measure is for securities firms only. It is the sum of customer loans, short-term reverse repurchase agreements and securities borrowing with customers maturing within one year net of haircut, long-term interbank loans receivable and reverse repurchase agreements and securities borrowing maturing after one year, securities holdings net of haircut, restricted cash (excluding amounts segregated for customers), receivables from customers, brokers and clearing organizations net of haircuts, all other non-insurance company-related or otherwise excluded assets, and off-balance-sheet credit equivalents net of haircut.

**Gross stable funding ratio (GSFR).** This measure is for securities firms only. It is the ratio of available stable funding to gross stable funding needs.

**Industry risk.** One of the two main analytical components (alongside economic risk) that determines our Banking Industry Country Risk Assessments (BICRA), designed to evaluate and compare global banking systems. BICRA is used in setting the anchor--the first step in determining an NBF1 rating. Industry risk is determined by the quality and effectiveness of bank regulation and the track record of authorities in reducing vulnerability to financial crises, the competitive environment of a country's banking industry--including the industry's risk appetite, structure, and performance--and possible distortions in the market. Industry risk also addresses the range and stability of funding options available to banks, including the role of the central bank and government.

**Issuer credit rating (ICR).** An S&P Global Ratings ICR is a forward-looking opinion about an obligor's overall creditworthiness. This opinion focuses on the obligor's capacity and willingness to meet its financial commitments as they come due. It does not apply to any specific financial obligation because it does not take into account the nature of and provisions of the obligation, its standing in bankruptcy or liquidation, statutory preferences, or the legality and enforceability of the obligation.

**Leverage ratio.** A ratio of debt to adjusted total equity, used when assessing finance companies.

**Liquidity coverage metric.** A ratio of balance sheet liquidity sources divided by balance sheet liquidity needs, used when assessing securities firms. Balance sheet liquidity sources are made up of broad liquid assets, excluding segregated assets plus available committed unsecured lines net of haircut. Balance sheet liquidity needs are made up of short-term wholesale funding plus payables to customers, brokers, and clearing organizations net of haircut, and off-balance-sheet commitments net of haircut.

**Loss experience.** Loss results from reductions in capital available due to business operations. These losses are typically credit-related and are associated with loans that default or are renegotiated with impairment to the lender (the finco). They may also stem from counterparty relationships in which there are payments owed by the finco to the counterparty. They may also be related to operational problems such as penalties assessed by regulators or in judicial settings to resolve credit-related business transactions. Finally, loss experience may also relate to market-based losses such as loss in value upon sale of one or more assets. Loss experience is the aggregation of such losses over specified periods of time.

**Net interest margin (NIM).** Net interest income divided by average interest earning assets on an annualized basis.

**Quality of capital.** An assessment of capital that considers the portion of capital consisting of adjusted common equity and the amount of double leverage used by an entity.

**Return on average assets (ROAA).** Net income after extraordinary items divided by average total assets.

**Revenue stability.** A measure that considers an entity's revenue dynamics and historical revenue stability.

**Risk-adjusted capital framework (RACF).** The globally consistent framework we use to measure a financial institution's capital.

**Risk-adjusted capital (RAC) ratio.** One of the primary capital metrics for finance companies. It is measured as total adjusted capital (TAC) divided by total risk-weighted assets. It reflects our expectations for the balance sheet, including earnings and anticipated capital management initiatives over a two-year horizon, with primary emphasis on the current year.

**Securities firm leverage ratio.** Measures simple balance sheet equity leverage. It is calculated one of two ways based on the accounting regime's use of netting for reported balance sheet derivatives. For firms that report derivative positions net by counterparty (as under U.S. generally accepted accounting principles [GAAP]), it is calculated as adjusted common equity divided by adjusted assets. For firms that report balance sheet derivatives on a gross basis (as under IFRS accounting), it is calculated as adjusted common equity divided by adjusted assets minus 90% of derivatives receivables.

**Short-term wholesale funding.** The sum of short-term interbank and debt market funding maturing within one year, repurchase agreements and securities lending, acceptances, and nonderivative trading liabilities.

**Stable funding needs (SFN).** Includes customer loans, a proportion of short-term reverse repurchase agreements with nonbanks, interbank loans and all reverse repurchase agreements with banks and nonbanks maturing after one year, potentially more risky and/or less liquid securities holdings depending on their asset type, restricted cash, all other nonderivative assets, and a proportion of off-balance-sheet credit equivalents.

**Stable funding ratio (SFR).** A ratio of a finco's available stable funding sources relative to its stable funding needs. A finco's SFR is precisely defined as for banks in "Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions," published July 17, 2013.

**S&P Global Ratings risk-weighted assets (RWA).** A measure that risk weights an entity's assets. It is calculated by multiplying an entity's exposure to asset classes by the respective risk weight we assign to each of those asset classes.

**Stand-alone credit profile (SACP).** S&P Global Ratings' opinion of an issue's or issuer's creditworthiness, in the absence of extraordinary intervention from its parent or affiliate or related government. We use lowercase letters, for example 'aaa', or 'aa', to designate SACPs, and may modify this symbol with a "+" or "-" sign, depending on the specificity of the relevant analysis. SACPs do not have outlooks and are not placed on CreditWatch.

**Total adjusted capital (TAC).** A globally consistent definition of the amount of capital a financial institution has available to absorb losses on a going-concern basis. TAC includes hybrid capital components that are, in our view, of somewhat weaker quality than those included in adjusted common equity, our measure of consolidated core capital. This reflects our view of the equity content of hybrid capital instruments and the equity-like characteristics of preferred stock. The formula for TAC is as per table 2 of the RACF criteria.

**Total equity** The sum of common shareholders' equity, minority interest-equity, and hybrid instruments with "high" or "intermediate" equity content.

**Value at risk (VaR).** A measurement of the potential loss in value of all or a subset of the trading book over a defined period for a given confidence interval.

## REVISIONS AND UPDATES

This article was originally published on Dec. 9, 2014. These criteria became effective on Dec. 9, 2014.

Changes introduced after original publication:

- We republished this article on Dec. 19, 2014, to add "Methodology For Mapping Short- And Long-Term Issuer Credit Ratings For Banks," published May 4, 2010, and "Commercial Paper I: Banks," published March 23, 2004, to the list of related criteria. These articles outline our methodology for mapping long-term ratings to short-term ratings, which we apply for nonbank financial institutions.
- Following our periodic review completed on Dec. 9, 2015, we updated our author contact information and removed some language related to the initial publication of these criteria, which was no longer relevant.
- Following our periodic review completed on Dec. 9, 2016, we updated our author contact information and removed some language related to the initial publication of these criteria,



which was no longer relevant. We also added a "Revision History" section and updated dates for related research.

- On Sept. 28, 2017, we corrected the following items, none of which has any implications for ratings: We corrected table 15, section 2, second row, by removing the reference to CLE. As described in paragraph 82, when the expected RAC ratio is below 3%, the capital subassessment is capped at very weak. It does not cap the overall CLE assessment at very weak. We also corrected the paragraphs referenced in the same row of the table to paragraphs 82 and 84-97. We also updated criteria references throughout the article, including showing box 3 as superseded.
- Following our periodic review completed on Nov. 23, 2017, we changed the "Revision History" section to the "Revisions And Updates" section and updated criteria references.
- On March 12, 2018, we implemented a nonmaterial change. We deleted box 3, "How To Compute RAC Ratios For Securities Firms," which was superseded by "Risk-Adjusted Capital Framework Methodology," published July 20, 2017, and updated criteria references in paragraphs 85 and 86.
- On Jan. 15, 2019, we republished this criteria article to make nonmaterial changes to update the contact information.
- On July 1, 2019, we republished this criteria article to make nonmaterial changes in connection with the publication of "Hybrid Capital: Methodology And Assumptions," "Insurers Rating Methodology," and "Group Rating Methodology." Specifically, we updated criteria references throughout the article and the footnotes to the first chart and tables 8 and 9. We also aligned terminology, changing "minimal equity content" to "no equity content" in table 25, and updated the "Related Criteria" section.
- On Jan. 21, 2020, we republished this criteria article to make nonmaterial changes to the contact information.
- On Oct. 19, 2020, we republished this criteria article to make nonmaterial changes. We deleted a sentence of noncriteria content relating to the expected frequency of committee outcomes from paragraph 67, and we updated article cross-references in paragraphs 2, 5, 85, and 207 and the "Related Guidance" list.
- On March 4, 2021, we republished this criteria article to make nonmaterial changes. In the definition of adjusted total equity in the glossary, we deleted the reference to deducting capital of insurance subsidiaries. This is because the starting point of the definition, total adjusted capital, already reflects this adjustment in line with "Risk-Adjusted Capital Framework Methodology," published July 20, 2017.
- On Oct. 11, 2021, we republished this criteria article to make nonmaterial changes. We updated paragraphs 40, 43, 46, 56, 60, 127, 134, 163, and 164 and table 9 to include examples describing how we incorporate environmental, social, and governance credit factors in our criteria framework. We also updated the "Related Publications" section.

## **RELATED PUBLICATIONS**

### **Superseded Criteria**

- Rating Securities Companies, June 9, 2004

## Partly Superseded Criteria

- Commercial Paper II: Finance Companies, March 22, 2004
- Finance Company Ratios, March 18, 2004
- Rating Finance Companies, March 18, 2004

## Related Criteria

- Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- Group Rating Methodology, July 1, 2019
- Hybrid Capital: Methodology And Assumptions, July 1, 2019
- Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Guarantee Criteria, Oct. 21, 2016
- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Corporate Methodology, Nov. 19, 2013
- Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Principles Of Credit Ratings, Feb. 16, 2011
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

## Related Guidance

- Guidance: Corporate Methodology, July 1, 2019
- Guidance: Applying The Risk-Adjusted Capital Framework Methodology, Sept. 13, 2018
- Guidance: Assumptions For Liquidity Stress Test Analysis Under "Nonbank Financial Institutions Rating Methodology", March 22, 2018

This article is a Criteria article. Criteria are the published analytic framework for determining Credit Ratings. Criteria include fundamental factors, analytical principles, methodologies, and /or key assumptions that we use in the ratings process to produce our Credit Ratings. Criteria, like our Credit Ratings, are forward-looking in nature. Criteria are intended to help users of our Credit Ratings understand how S&P Global Ratings analysts generally approach the analysis of Issuers or Issues in a given sector. Criteria include those material methodological elements identified by S&P Global Ratings as being relevant to credit analysis. However, S&P Global Ratings recognizes that there are many unique factors / facts and

circumstances that may potentially apply to the analysis of a given Issuer or Issue. Accordingly, S&P Global Ratings Criteria is not designed to provide an exhaustive list of all factors applied in our rating analyses. Analysts exercise analytic judgement in the application of Criteria through the Rating Committee process to arrive at rating determinations.

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