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China Ratings

Low Leverage Underpins Credit Quality of Chinese Securities Firms Amid Heightened Market Uncertainty

A Study on Credit Quality Differentiation of Securities Firms in China

February 16, 2022

Key Takeaways

- Securities firms' high exposure to the equity market is partially balanced out by the industry's low leverage.
- We believe Chinese securities firms are subject to prudent and rigorous regulation with supervisory requirements on their capital, risk and liquidity metrics, which is another contributing factor to the sector's stability.
- Increased stock market activities have supported securities firms' earnings in recent years. Brokers have also reduced their stock-pledged lending assets, reducing their credit risk exposure. These factors are positive for the sector's credit outlook for the next 12 months.
- We believe Chinese securities firms show varying credit quality. Based on our testing results, the indicative stand-alone credit quality of securities firms ranges from [a_{spc}+] to [b_{spc}-], and indicative issuer credit quality ranges from [AA_{spc}] to [B_{spc}-].
- We believe that the securities sector poses small systemic risk to the financial system. More than 90% of securities sector assets are with brokers with investment grade credit quality.

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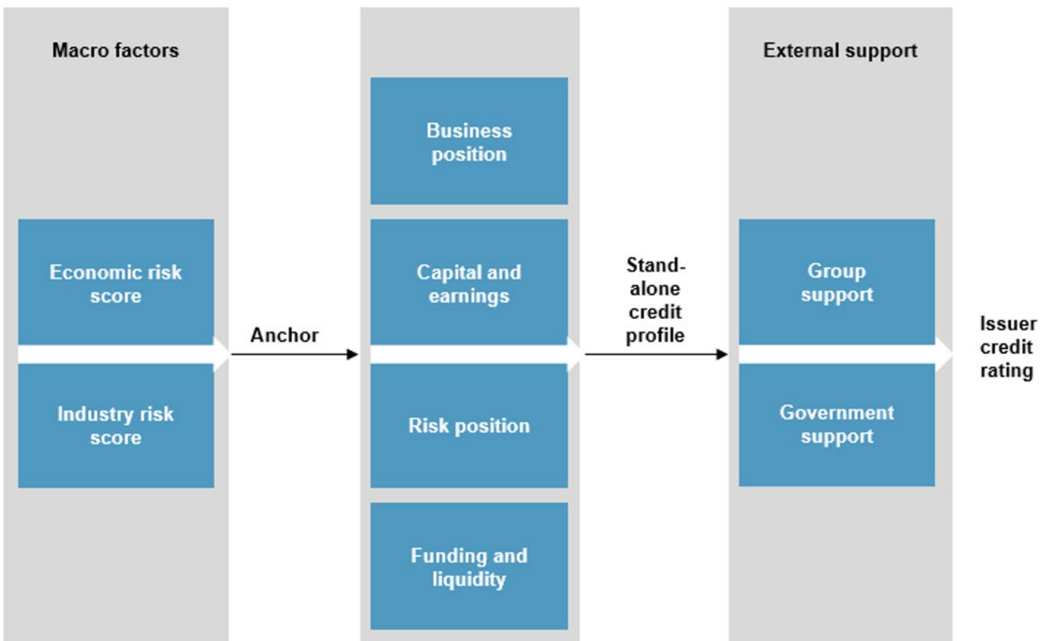
Overview

S&P Ratings (China) Co., Ltd. (S&P China) has conducted a desktop analysis of a selection of 100 major securities firms in China, covering almost 100% of China's securities industry by assets. This desktop analysis is based on S&P Global (China) Ratings Financial Institutions Methodology. We typically determine the stand-alone credit quality based on our assessment of an institution's anchor, a starting point, and then incorporate its own characteristics compared with the anchor. S&P Global (China) Ratings typically applies an anchor of 'bbb-' for securities firms. The entity-specific factors that we may use to adjust from the anchor include business position, capital & earnings, risk position, and funding & liquidity. We then determine the issuer credit quality based on the stand-alone credit quality and our assessment of potential group and government influence.

Chart 1

We Use the Same Analytic Framework for Banks, Securities Firms and Finance Companies

Financial Institutions Methodology Framework



Note: After assessing the issuer's entity-specific factors, a holistic assessment may be applied to evaluate its credit characteristics in aggregate and versus peers before arriving at SACP.

Source: S&P Global (China) Ratings

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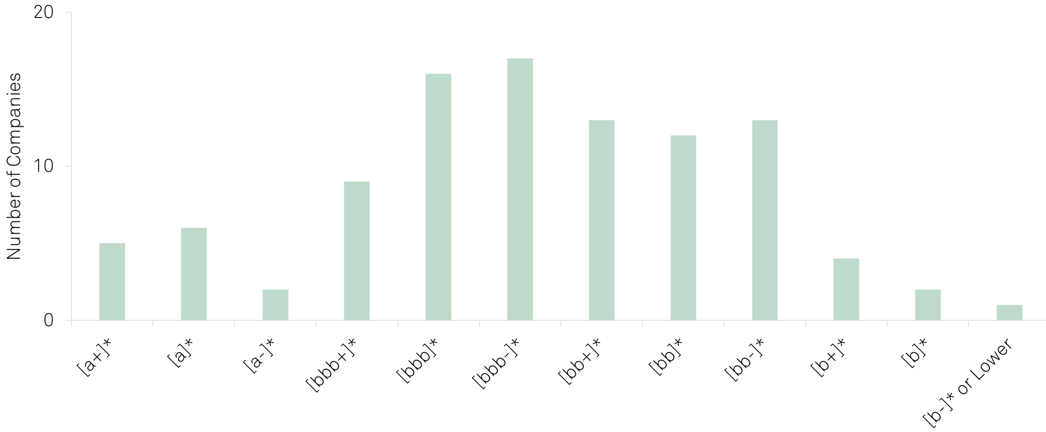
We believe Chinese securities firms show varying credit quality. Based on our testing results, the indicative stand-alone credit quality of securities firms ranges from [a_{spc}+] to [b_{spc}-], and indicative issuer credit quality ranges from [AA_{spc}] to [B_{spc}-]. Our testing results show that business franchise, profitability and risk management are the most important factors to differentiate the stand-alone credit quality of securities firms. Issuer credit quality incorporates possible government or group support in times of stress.

Chart 2

Indicative Stand-Alone Credit Quality of Securities Firms Ranges From [a_{spc}+] To [b_{spc}-]

Distribution of Indicative Stand-alone Credit Quality of 100 Major Securities Firms



Note 1: Our assessment of indicative stand-alone credit quality doesn't consider the possibility of group or government support in times of stress.

Note 2*: The indicative credit quality distributions expressed in this report are only S&P China's indicative views of credit quality derived from a desktop analysis based on public information without interactive review with any particular institution or the full credit rating process such as a rating committee. The opinions expressed herein are not and should not be represented as a credit rating and should not be taken as an indication of a final credit rating of any particular institution.

Source: S&P Global (China) Ratings.

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Table 1

Medians of Key Business and Financial Metrics of 100 Major Securities Firms Tested

Indicative Stand-alone Credit Quality (In 2020 / as of End of 2020)	[a]* Category	[bbb]* Category	[bb]* Category	[b]* Category
Total Assets (bil.)	402.6	53.5	16.7	8.7
Market Share by Total Assets (%)	4.6	0.6	0.2	0.1
Brokerage Business Ranking	7	34	70	75
Investment Banking Business Ranking	7	36	59	81
Proprietary Investment Business Ranking	7	37	59	92
Regulatory Financial Leverage Ratio (X)	3.6	2.7	2.1	1.1
Return on Equity (%)	9.6	6.3	3.7	0.2
Regulatory Ratings	AA	A	BB	CCC

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Sources: Public information of securities firms, CSRC, SAC, collected and adjusted by S&P Global (China) Ratings.

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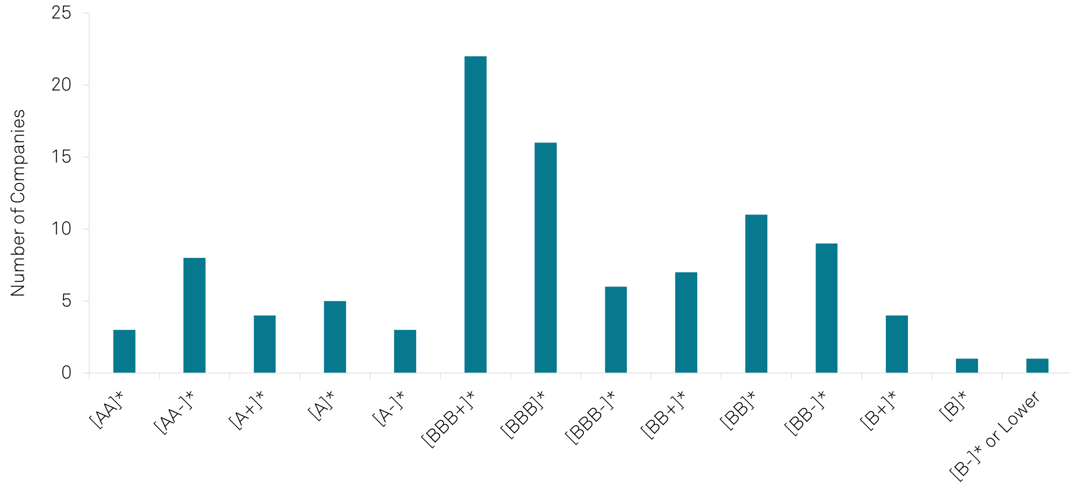
Given the financial disintermediation trend in China and the continuous deepening of China's capital market, considering the leading roles the securities firms play in this process, we believe the securities industry is strategically important to the government. In addition, there have been actual cases where the government has bailed out securities firms in crisis. Therefore, potential government support is considered in our assessment of securities firms but to a lesser degree when compared to commercial banks, the failure of which would have more severe financial and social consequences. In addition, we also consider group support where appropriate.

Chart 3

Indicative Issuer Credit Quality of Securities Firms Ranges From [AA_{spc}] to [B_{spc}-]

Distribution of Indicative Issuer Credit Quality of 100 Major Securities Firms



Note 1: Our assessment of indicative issuer credit quality considers the possibility of group or government support in times of stress.

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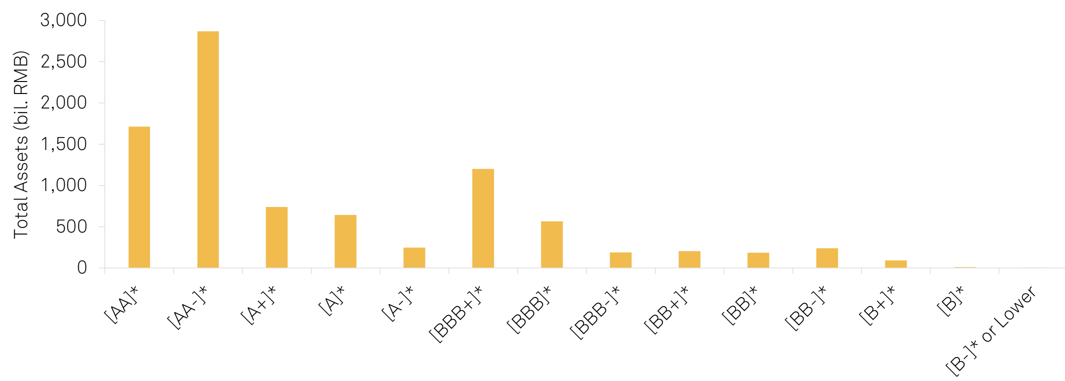
We believe that the securities sector poses very small systemic risk to the financial system. More than 90% of securities sector assets are with brokers with investment grade credit quality. Securities firms with indicative issuer credit quality of [BB_{spc}] and [B_{spc}] have a regulatory financial leverage ratio of about 2 times and 1 time respectively. The very low leverage creates a comfortable buffer against default risk, even for brokers with weaker credit quality.

Chart 4

More Than 90% of the Assets of Securities Sector are With Firms of Issuer Credit Quality at [BBB_{spc}-] or Above

Distribution of Indicative Issuer Credit Quality of 100 Major Securities Firms by Assets as of End of 2020



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We believe that the overall credit outlook for China's securities sector should remain stable because of effective regulatory oversight and relatively low leverage. Under the tight regulation of the China Securities Regulatory Commission ("CSRC"), securities firms have been improving their underwriting standards and risk management. The sector has also maintained a leverage level that is relatively low compared to banks and other non-bank financial institutions ("NBFIs"). The low leverage gives this sector comfortable financial flexibility to weather heightened market volatility.

Anchor

In our national scale ratings, the anchor is a relative ranking of creditworthiness of different financial subsectors. Typically, we decide on our bank anchor first. For NBFIs (including securities firms and finance companies), we adjust the anchor to account for differences between banks and NBFIs as well as potentially for sector- and entity-specific factors. The anchor differs from sector to sector because NBFIs face additional funding, economic, or competitive risks, or a weaker institutional framework.

Considering the economic risk and industry risk faced by China's securities industry, we typically apply an anchor of "bbb-" to securities firms operating in China. Securities industry's "bbb-" anchor reflects the typical incremental risks that the sector face relative to banks whose anchor is "bbb+". We set the anchor for securities firm two notches below the bank anchor for the follow reasons:

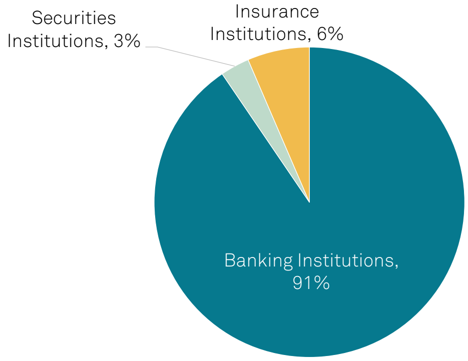
- Securities firms don't have access to public deposit base which increases liquidity and funding risk relative to banks.
- Securities firms have higher competitive risk, both among themselves and relative to banks, because of lower barriers to entry as well as more volatile or fragmented business conditions.
- Securities firms' economic risks may exceed those faced by banks because they are exposed to equity market volatility, given their dependence on market liquidity to monetize assets they own.

The securities industry is a relatively small player compared to the banking sector in terms of asset size. As of the end of 2021Q2, about 90.5% of the financial sector's assets were with banking institutions, 6.5% by insurers and 3% by securities firms.

Chart 5

Securities Industry Accounted for 3% of Total Assets of Financial Sector in China

Asset Breakdown of Different Financial Sub-sectors as of End of 2021 Q2



Source: PBoC, collected and adjusted by S&P Global (China) Ratings.

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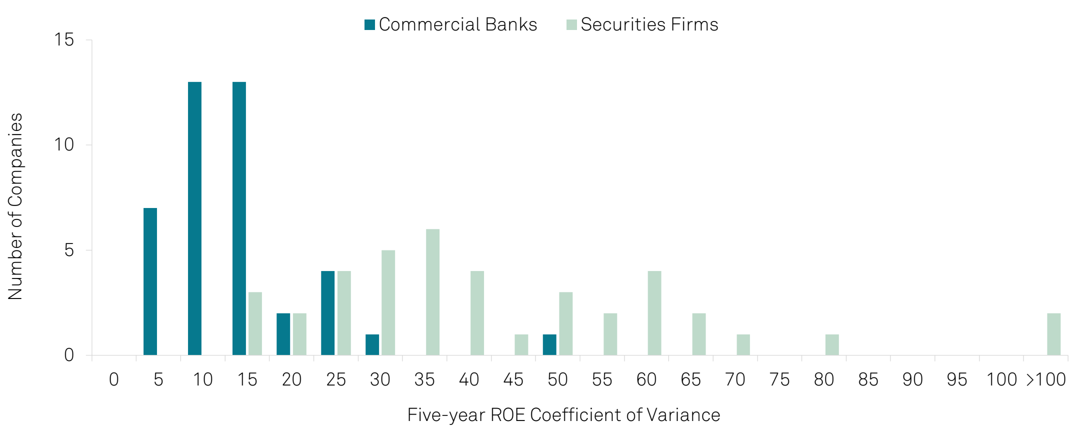
Chart 6

Securities Firms' Earning Stability is Weaker than Banks

Distribution of Five-year ROE Coefficient of Variance of Major Securities Firms and Commercial Banks



Note: ROE coefficient of variance is the standard deviation of the securities firm's ROEs divided by the absolute value of the mean of its ROEs.

Source: Public information of companies, collected and adjusted by S&P Global (China) Ratings.

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The securities sector is highly competitive in China. China has about 140 securities firms in total, among which, 36 are subsidiaries of other securities firms. The market is fragmented. The top ten securities firms have about 53% of the market share by assets, and 46% of the market share by revenue. Due to intense competition among securities firms, the pricing of brokerage business and investment banking business have come under pressure, weighing on industry profitability. Although China has accelerated opening up of its financial sector, we believe competitive pressure from foreign players should stay limited in the foreseeable future.

Although we believe the banking sector will remain dominant, China's efforts to cut out the middle man in the financial sector and to develop a dynamic capital market should see healthy growth potential for the securities industry in China. In the first half of 2021, securities firms recorded a 25% growth rate (YoY) of outstanding assets, 16 percentage points higher than the overall financial sector's asset growth rate of 9%.

Business Position

Business position assesses the strength of a firm's business operations relative to peers. The assessment is based on three subfactors, (1) business stability, (2) business diversity, and (3) management and governance. The analysis is both qualitative and quantitative. We have a six-point scale to assess business position of securities firms, score 1 means the strongest, and score 6 means the weakest.

Table 2

Analytical Framework for Business Position Assessment of Securities Firms

Subfactors	Explanations
Business stability	Business stability, the first business position subfactor, assesses the predictability of continuing business volumes in the face of potential economic and market fluctuations. It is about the stability or fragility of a firm's business franchise and operating performance through business cycles. Key indicators we use include market position, revenue stability and customer base.
Business diversity	The concentration or diversity of business activities. Key indicators include contributions of different business lines and geographies.
Governance, management and strategy	The quality of management, strategy, and corporate governance. Key indicators include governance and transparency, ownership structure, quality of management, strategic positioning, operational effectiveness, financial management, and policies.

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Table 3

Business Position Assessment of Securities Firms

Score	Notching	Typical Profile	Core Metrics Threshold - Asset market share
1	+2	Core operating performance is expected to be much stronger and less volatile than those of peers, with diversified business lines which help the firm to remain resilient in the face of potential economic and market fluctuations. The firm's business mix is more stable and less risky than peers, with no material high-risk business lines; it has a very stable and strong market position and sticky customer base.	>=3%
2	+1	Core operating performance is expected to be stronger and less volatile than those of peers, with diversified business lines which help the firm to remain resilient in the face of potential economic and market fluctuations. The firm's business mix is more stable and less risky than peers. In addition, it has a stable or strong market position, and stable customer relationships represent the majority of revenue.	>=1.5%, <3%
3	0	Core operating performance is expected to be average compared to those of peers, and its market position and the nature of its businesses, revenue, products, and customer relationships do not represent incremental risk above the industry average level. We expect the firm to demonstrate revenue stability on par with peers. The anchor of "bbb-" already recognizes that the securities sector's business stability is inherently more volatile than that of banks which has an anchor of "bbb+". If a firm experiences business volatility that is consistent with expectations reflected in the anchor, that firm likely would still have an "3/adequate" business stability assessment.	>=0.5%, <1.5%
4	-1	Core operating performance is expected to be somewhat weaker compared to those of peers. A weaker market position, higher risk, or more confidence-sensitive business mix is only partially offset	>=0.2%, <0.5%

		by any strengths, and this leads us to expect weaker revenue stability relative to peers, thus demonstrating modest incremental risk above the industry average level. The assessment is typically "4/moderate" if the entity has higher-risk businesses, as demonstrated by materially less stable revenue and profitability.	
5	**-2**	Core operating performance is expected to be weaker compared to those of peers. The stability of the firm's business mix, customer confidence sensitivity, or expected revenue stability are materially weaker than average. The assessment is "5/weak" if the entity is not expected to achieve sustainable profitability. However, low profitability, if caused by risk mitigation efforts instead of lack of market position, does not limit the assessment to "5/weak" or "6/very weak" unless anticipated to be prolonged.	<0.2%
6	**-3**	Core operating performance is expected to be much weaker compared to those of peers, and the assessment is typically "6/very weak" if the entity is projected to consistently fail to achieve profitability. 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.	N.A.

Note: The thresholds used in our testing is only the starting point of scoring. We also consider other qualitative and quantitative factors, so our final notching conclusion may differ from the conclusion drawn from the preliminary threshold analysis.

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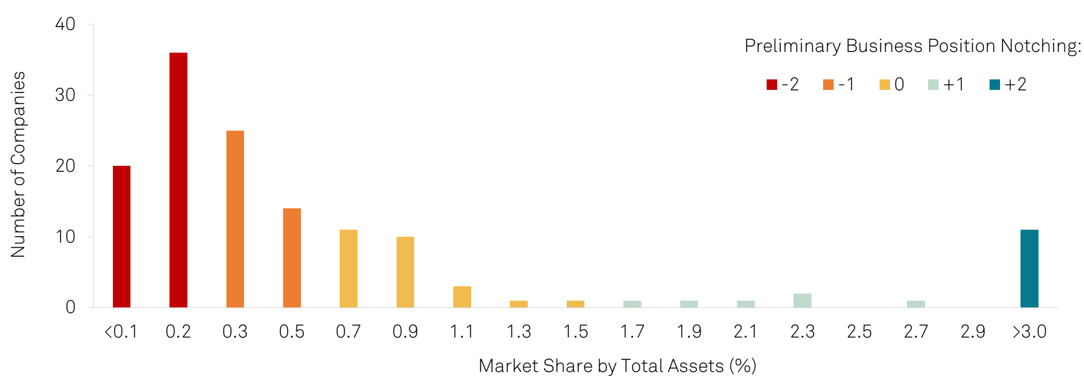
The indicators that inform our view of business stability include (1) market position, (2) business mix, (3) revenue stability, and (4) customer base. Market position considers the size and stability of market share, as well as profitability. Business mix considers the risk of the mix of business lines as well as the risk of business lines themselves, particularly exposure to confidence-sensitive business. Revenue stability considers a firm's revenue dynamics and historical revenue stability. Customer base reflects a firm's exposure to customer confidence sensitivity (i.e., the stability and reliability of customer relationships).

We typically use market share as the starting point for our analysis of business stability. Given the high volatility of the market, we focus on securities firms' ability to maintain and grow their market position through economic cycles.

Chart 7

Market Share is the Driving Factor for Preliminary Assessment of Business Position

Distribution of Asset Market Share of Securities Firms as of End of 2020



Note: The preliminary business position assessment is based on market share in the securities industry. Our final business position assessment result may be different from the preliminary assessment after we considering other important factors which affect business stability of a securities firm.

Source: SAC, collected and adjusted by S&P Global (China) Ratings.

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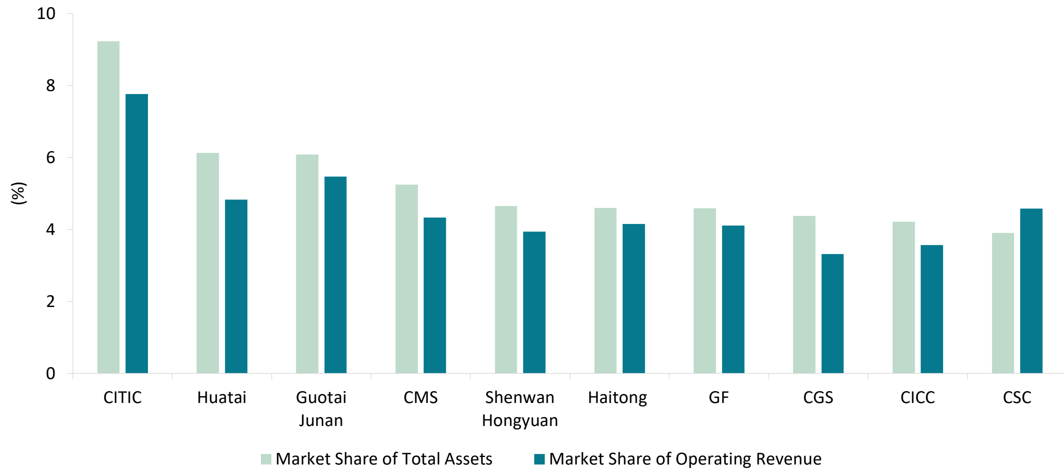
Chart 8

Top 10 Firms Accounted for About Half of the Operating Revenue of the Securities Industry

Market Shares of China's Top Ten Securities Firms by Assets as of End of 2020



Note: CITIC-CITIC Securities, CMS-China Merchants Securities, GF-GF Securities, CGS-China Galaxy Securities, CICC-China International Capital Corporation, CSC-China Securities Corporation.

Source: SAC, collected and adjusted by S&P Global (China) Ratings.

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Table 4

Revenue Ranking of Securities Firms in 2020

Ranking	Brokerage	Investment banking	Asset management	Margin lending	Proprietary investment
1	CITIC	CSC	Orient	CITIC	CITIC
2	Guotai Junan	CITIC	CITIC	Guotai Junan	CSC
3	CMS	CICC	Huatai	Huatai	Huatai
4	Guosen	Haitong	Guotai Junan	CGS	CICC
5	GF	Huatai	Everbright	Haitong	CMS
6	CGS	Guotai Junan	Haitong	Shenwan Hongyuan	Shenwan Hongyuan
7	Huatai	CMS	GF	CMS	Guotai Junan
8	Shenwan Hongyuan	Everbright	Shenwan Hongyuan	GF	Haitong
9	CSC	Guosen	Caitong	Guosen	Orient
10	Haitong	Sinolink	CICC	CSC	CGS

Note: CITIC-CITIC Securities, CMS-China Merchants Securities, GF-GF Securities, CGS-China Galaxy Securities, CICC-China International Capital Corporation, CSC-China Securities Corporation.

Source: SAC, collected and adjusted by S&P Global (China) Ratings.

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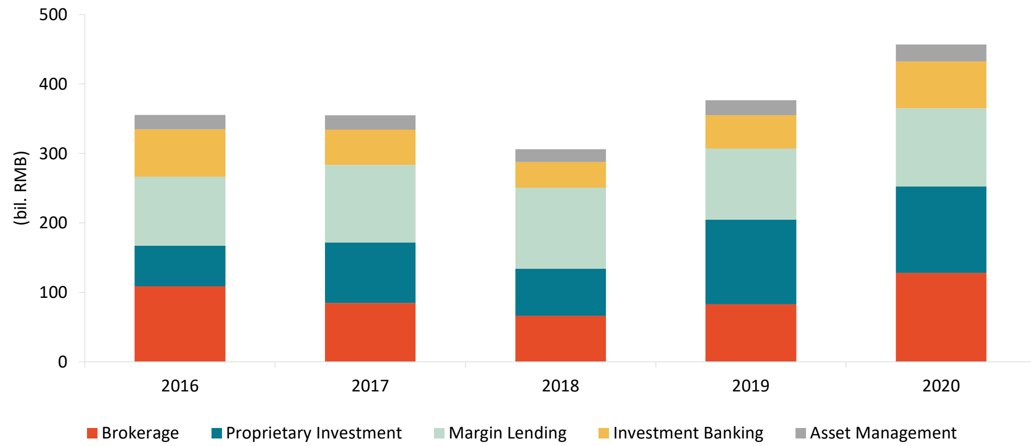
Business diversity is the second subfactor of the business position assessment. We assess it by analyzing three indicators: business line revenue diversity, geographic diversity, and customer revenue concentrations (counterparty concentration).

Chart 9

Securities Sector Has Diversified Revenue Sources

Breakdown of Revenue of Securities Sector



Source: SAC, collected and adjusted by S&P Global (China) Ratings.

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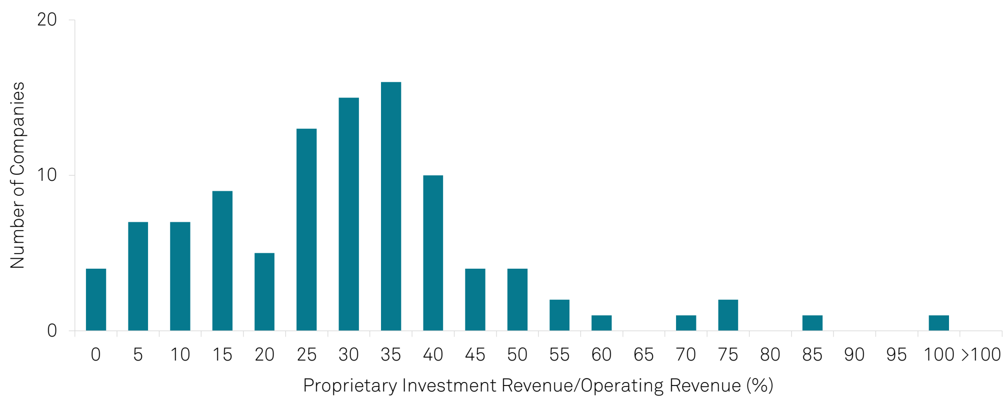
Chart 10

Proprietary Investment is a Major Contributor to Securities Firms' Revenue

Distribution of Proprietary Investment Revenue/Operating Revenue Ratio in 2020



Source: SAC, collected and adjusted by S&P Global (China) Ratings.

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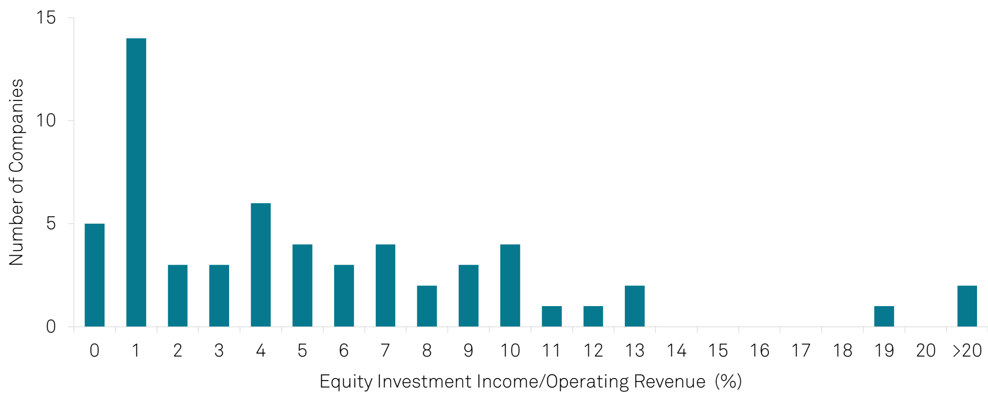
Chart 11

Return from Equity Investment Contributes to about 5% of Securities Firms' Revenue

Distribution of Equity Investment Income/Operating Revenue in 2020



Source: SAC, collected and adjusted by S&P Global (China) Ratings.

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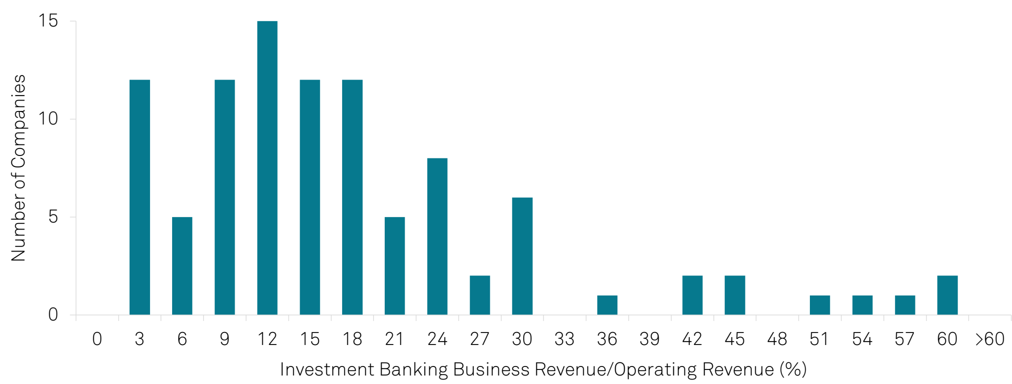
Chart 12

Only Large National Securities Firms Have Strong Revenue from Investment Banking

Distribution of Investment Banking Business Revenue/Operating Revenue Ratio in 2020



Source: SAC, collected and adjusted by S&P Global (China) Ratings.

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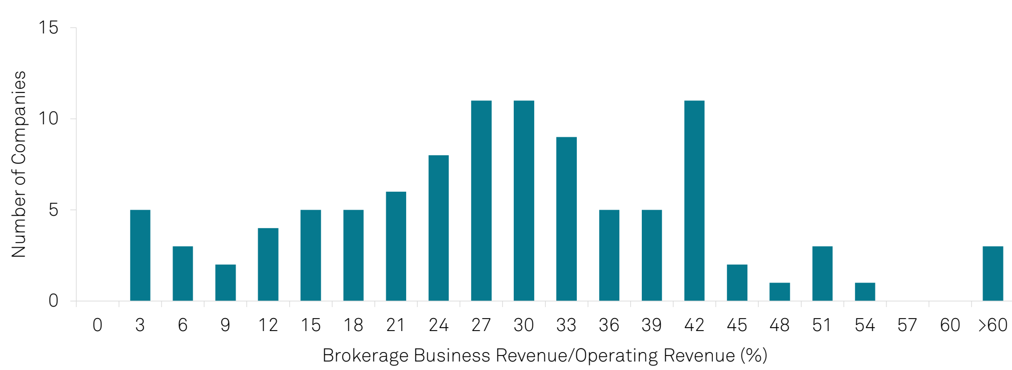
Chart 13

Brokerage Commissions are Very Important for Regional Securities Firms

Distribution of Brokerage Business Revenue/Operating Revenue Ratio in 2020



Source: SAC, collected and adjusted by S&P Global (China) Ratings.

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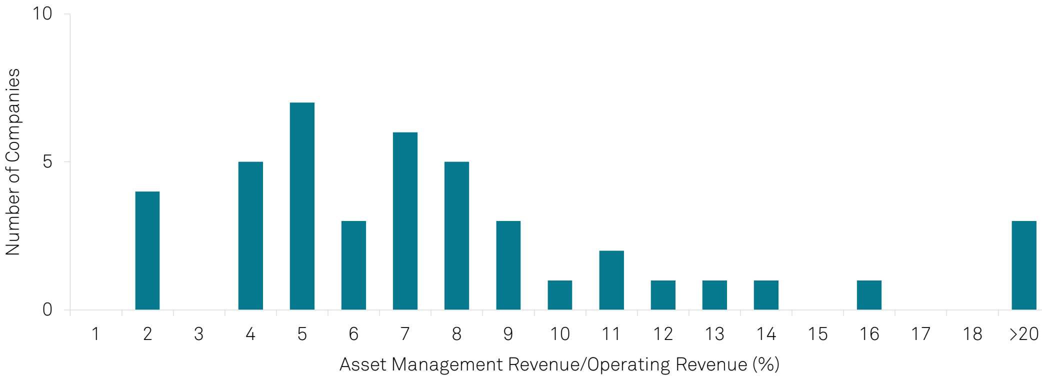
Chart 14

Return from Asset Management Contributes to 8% of Securities Firms' Total Revenue

Distribution of Asset Management Revenue/Operating Revenue Ratio in 2020



Source: SAC, collected and adjusted by S&P Global (China) Ratings.

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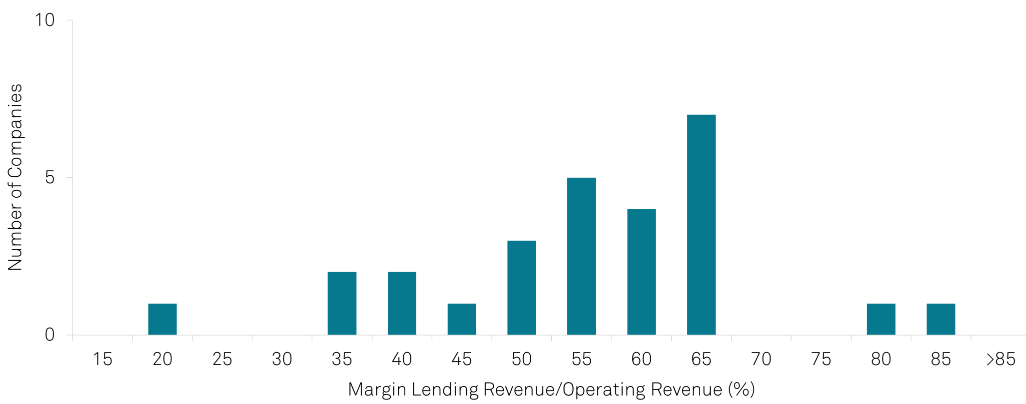
Chart 15

Margin Lending Revenue is Very Important for Securities Firms

Distribution of Margin Lending Revenue/Operating Revenue Ratio in 2020



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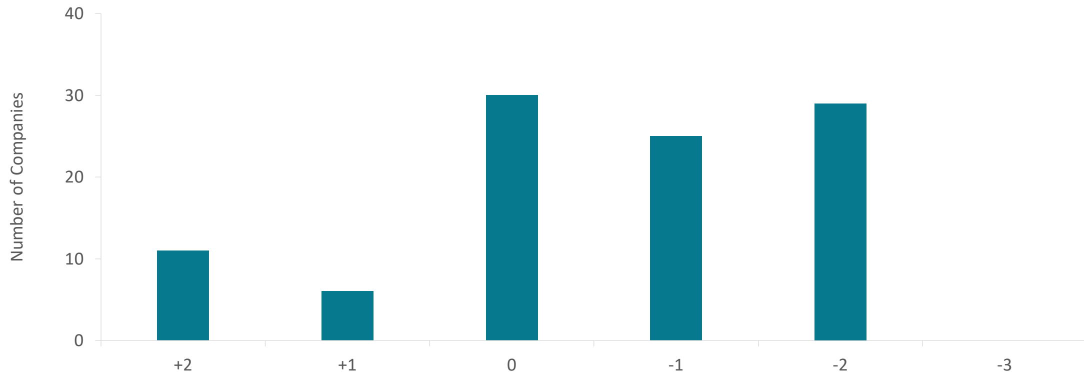
Management and governance, the third business position subfactor, addresses how management's strategic competence, organizational effectiveness, risk management, and governance practices shape an issuer's competitiveness in the marketplace, the strength of its financial risk management, and the robustness of its governance. Our approach to assessing securities firms' management/governance is similar to that for banks and fincos.

Chart 16

China has a Few Large Securities Firms and Many Small Ones

Distribution of Indicative Business Position Notching of 100 Major Securities Firms



Note 1: The notching is applied to the "bbb-" anchor of securities firms as part of the SACP assessment.

Note 2: The indicative notching expressed in this report is S&P China's indicative views of risk factors derived from a desktop analysis based on public information without interactive review with any particular institution or the full credit rating process such as a rating committee (except for some institutions for which we have assigned ratings on). The opinions expressed herein are not and should not be represented as part of a credit rating.

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Capital & Earnings

Capital and earnings, the second SACP factor, 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 analysis for securities firms addresses the presence of high absolute leverage (debt to equity ratio), the quality of capital, and the ability of earnings to offset losses. We have a six-point scale to assess capital/leverage of securities firms, where 1 means the strongest capital, and 6 the weakest.

Table 5

Summary of Capital & Earnings Assessment Approach for Securities Firms

Step		Key Analysis Factor
Step 1	**Whether an entity can meet regulatory requirement on capital/leverage**	The first step is to determine whether the entity has breached or is in danger of breaching minimum regulatory requirements (if applicable) in order to maintain its license and operations. When an entity's regulatory capital metrics are very close to regulatory requirements, it may affect the firm's flexibility to manage capital and business growth. Therefore, if a firm is close to breaching regulatory requirement or has already breached them, we may apply an unfavorable score for its capital & earnings.
Step 2	**Assess the core capital metrics to arrive at the initial capital & earnings score**	
2.1	**Calculate the leverage ratio of the company**	leverage ratio = adjusted total debts/adjusted total equity. Any under-provisioning amount, other erosion to equity which has not been reflected in the reported equity number, or any part of the equity which we believe cannot serve as loss absorption resources would be deducted to arrive at the adjusted equity.
2.2	**Arrive at initial capital & earnings score using the leverage ratio**	We apply the leverage ratio cutoff points in table 6 on the actual leverage ratio from most recent period to arrive at the initial score. Then we consider whether any factors, such as acquisitions, debt issuances, and large shareholder payouts, could significantly alter that measure on a forward-looking basis.

Step 3	Assess capital quality, earning capacity, and earning quality to adjust the initial capital & earnings score to arrive at the final score	
3.1	**Assess capital quality**	Our analysis of the quality, management and flexibility of capital may include the following factors: (1) what portion of capital is made up of hybrid instruments; (2) the level of reserves for credit losses and whether they may add significantly more or less to loss absorption ability; (3) the approach to capital management exercises by the management and shareholders; (4) financial flexibility; and (5) double leverage.
3.2	**Assess earning capacity**	We base our analysis of earnings capacity on a number of factors and ratios. We look at quantitative and qualitative indicators of an FI's ability to internally generate capital to support its business franchise and cover losses. We primarily consider performance over the last three to five years (or longer), as well as our forward-looking expectations for return on average assets.
3.3	**Assess earnings quality**	Our assessment of earnings quality considers factors such as the proportion of revenues from stable recurring resources, earnings volatility, and the frequency of nonrecurring revenue and expenses. We may also use this adjustment to take account of the capacity for earnings to cover normalized losses. Volatile earnings diminish our confidence in earnings' ability to provide a cushion against potential losses. Earnings quality deteriorates as each of the following increases: trading income to total revenues, investment banking revenue to total revenue, other market-sensitive income to total revenues, and cost-to-income ratio. In contrast, earnings derived from revenue that is driven by recurring sources and high expense flexibility support earnings stability over time.
3.4	**Adjust initial capital & earnings score**	When a firm's leverage ratio is near the threshold of an initial capital and earnings score, its capital quality, earnings capacity and quality assessment would probably have a stronger influence on its final capital and earnings score. Factors we may consider include (1) the strength and stability of the earnings, which may strengthen or weaken a firm's capacity to absorb losses through the cycle; (2) whether a firm can generate sufficient earnings to support its balance sheet growth without substantial increase in leverage; (3) the issuer's capability and willingness to build capital through retained earnings and our assessment on dividend payout ratio.

Source: S&P Global (China) Ratings.

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Table 6

Assessment of Capital & Earnings of Securities Firms

Score	Notching	Typical Profiles	Core Metrics Threshold – Leverage Ratio
1	+2	We consider capital & earnings as having a material positive impact on the SACP. We expect the leverage ratios adjusted by S&P Global (China) Ratings to be very low for at least the next 12 months.	<= 1
2	+1	We consider capital & earnings as having a positive impact on the SACP. We expect the leverage ratios adjusted by S&P Global (China) Ratings to be low for at least the next 12 months.	> 1 and <= 3
3	0	We consider capital & earnings as having a neutral impact on the SACP. We expect the leverage ratios adjusted by S&P Global (China) Ratings to be moderate at least for the next 12 months, and we believe the securities firm can comfortably meet regulatory capital requirements in a stress scenario.	> 3 and <= 5

4	**-1**	We consider capital & earnings as having a marginally negative impact on the SACP. We expect the leverage ratios adjusted by S&P Global (China) Ratings to be somewhat high in the next 12 months.	> 5 and <= 7
5	**-2**	We consider capital & earnings as having a negative impact on the SACP. We expect the leverage ratios adjusted by S&P Global (China) Ratings to be high in the next 12 months.	> 7 and <= 12
6	**-3**	We consider that capital & earnings materially constrains the SACP. We expect the leverage ratios adjusted by S&P Global (China) Ratings to be very high and the securities firm has a high risk of breaching regulatory minimum requirements even in a base-case scenario.	> 12

Note 1: Leverage ratio = adjusted total debts/adjusted total equity.

Note 2: For certain securities firms that meet the following conditions, the initial capital & earnings score typically reflects our expectations for their debt to EBITDA, instead of leverage ratio. This is the case for securities firms that have very limited credit and market risk associated with their business model (i.e., those where the following activities are minimal: amount of securities on their balance sheets, cleared or held customer positions, and counterparty risk or other credit and market risks).

Note 3: The thresholds used in our testing are only the starting point of scoring. We also consider other qualitative and quantitative factors, so our final notching conclusion may differ from the conclusion drawn from the preliminary threshold analysis.

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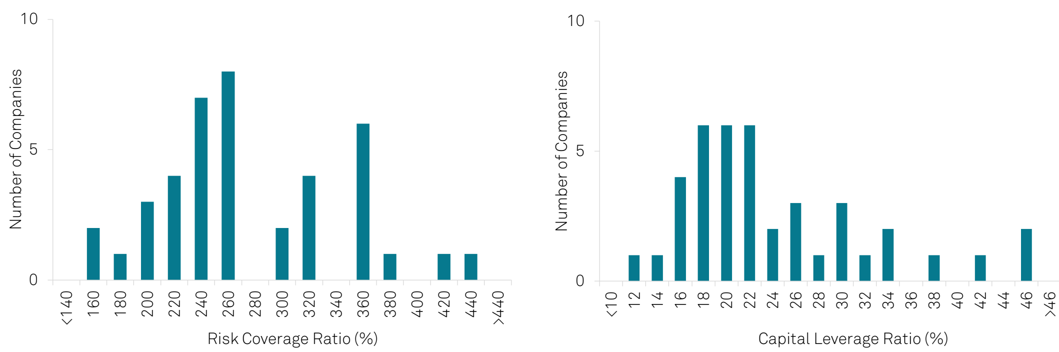
Our capital assessment of securities firms is a combination of regulatory capital and leverage ratios. The first step of analysis is to determine whether the securities firm can meet the regulatory capital requirements in the next 12 months. If a securities firm can meet regulatory capital requirements for its license--but by a narrow margin, and if we believe it is “at risk” of breaching its regulatory requirements in case of plausible adverse developments since its regulatory capital ratios are close to breaching levels, we typically would apply one negative notching. When a securities firm is in breach of legal regulatory minimum requirements or if we believe there is a high probability of breaching regulation requirements even in a base-case scenario, we typically would apply more negative notching of up to 3 notches.

All securities firms we tested can meet the regulatory capital requirements, and the majority of them are above the regulatory minimum by a large margin. CSRC has two capital-related ratios for securities firms. One is risk coverage ratio with a minimum regulatory requirement of 100%, and the other is capital leverage ratio, with a minimum requirement of 8%. As of the end of 2020, the industry average of the two ratios were 252% and 24% respectively, much higher than the minimum requirements of 100% and 8%.

Chart 17

Major Securities Firms Enjoy Good Capitalization

Distribution of Regulatory Risk Coverage Ratio and Capital Leverage Ratio of 40 Listed Securities Firms as of End of June 2021



Source: Public information of companies, collected and adjusted by S&P Global (China) Ratings.

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The second step is to assess the leverage ratio (adjusted total debts/adjusted total equity). The volatility in the earnings of many securities firms can make forecasting their capital more difficult than forecasting bank capital. For securities firms, we start with the leverage ratio from the most recent period and consider whether any factors, such as acquisitions, debt issuances, and large shareholder payouts, could significantly alter that measure on a forward-looking basis.

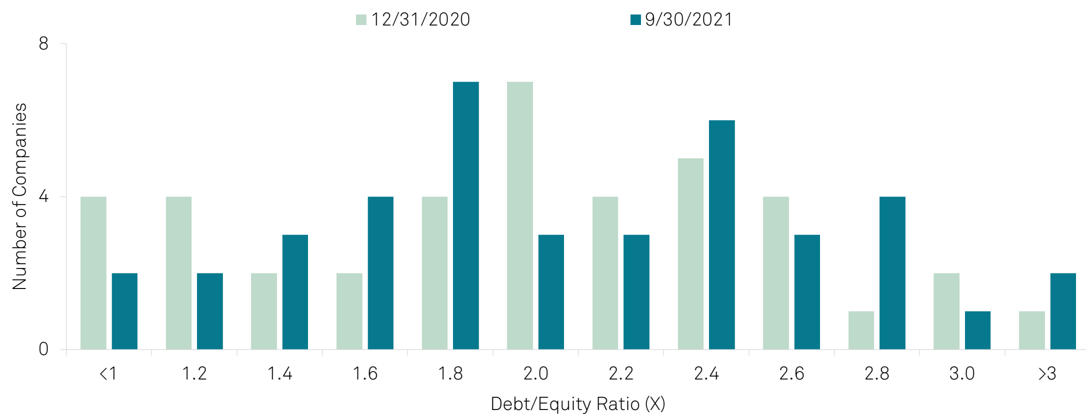
In our view, Chinese securities firms' high exposure to the equity market is partially balanced out by the industry's relatively low leverage ratio compared to banks and other NBFIs. To ensure cross-sector comparability, the leverage ratio cutoff points we apply to securities firms are the same as the ones which we use on finance companies with risk profiles less comparable to banks.

We expect industry leverage to remain moderate in the next 12 months. As of September-end 2021, the average debt/equity ratio of the 40 listed securities companies was 2.4X, similar to the 2.3X level at year-end 2020. This conservative leverage level has helped the industry remain resilient against periodic market turmoil in recent years.

Chart 18

Major Securities Firms Maintain Their Low Leverage

Distribution of Debt/Equity Ratio of 40 Listed Securities Firms



Source: Public information of companies, collected and adjusted by S&P Global (China) Ratings.

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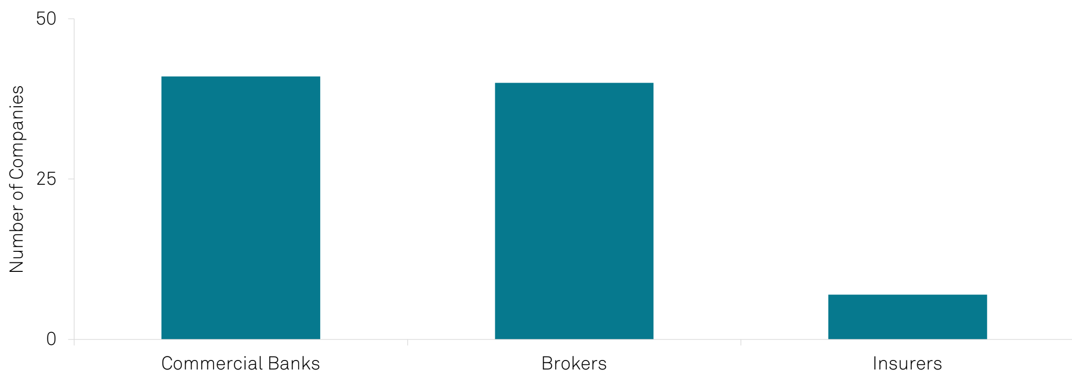
Compared with other financial institutions, securities firms generally have good access to the stock market. Among the 100 securities firms in China, 40 of them are listed on the A share stock market.

Chart 19

Securities Firms Have Good Access to the Stock Market for Capital Raising

Number of A -Share Listed Banks, Securities Firms and Insurers as of End of November 2021



Source: Wind, collected and adjusted by S&P Global (China) Ratings.

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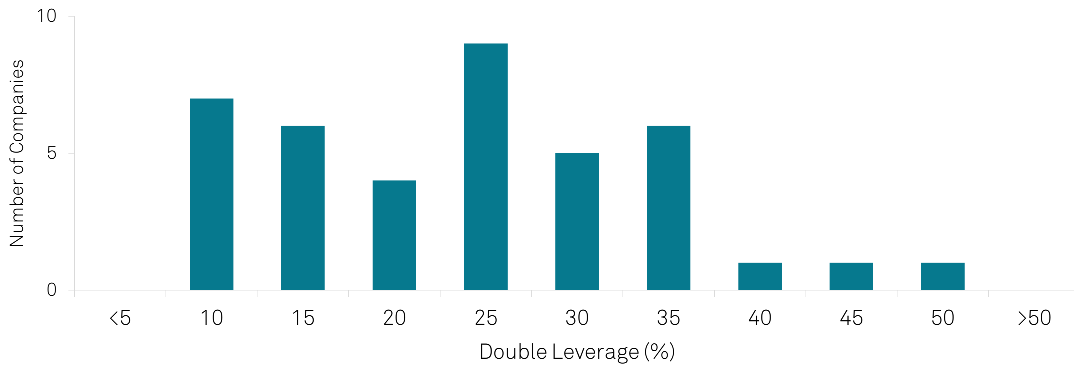
Our capital assessment also takes into consideration capital quality. One important ratio we look at is double leverage ratio which is calculated as (long-term investment on stocks of parent company/total equity of parent company). The average double leverage ratio of the 40 listed securities firms we tested was only 21.5% as of the end of 2020, indicating good capital quality. The low double leverage is caused by limited number of subsidiaries and limited use of holding company structures. Securities firms typically concentrate their business operations at the group level.

Chart 20

The Securities Sector has Low Double Leverage

Distribution of Double Leverage of 40 Listed Securities Firms as of End of 2020



Source: Public information of companies, collected and adjusted by S&P Global (China) Ratings.

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Another factor we consider for capital quality is the use of hybrid instrument in capital structure. We may hold a negative view if a securities firm's use of hybrid instruments is significantly above the industry average. In the domestic market, securities firms issue both subordinated bonds (as a liability item on the balance sheet) and subordinated perpetual bonds (as equity items on the balance sheet).

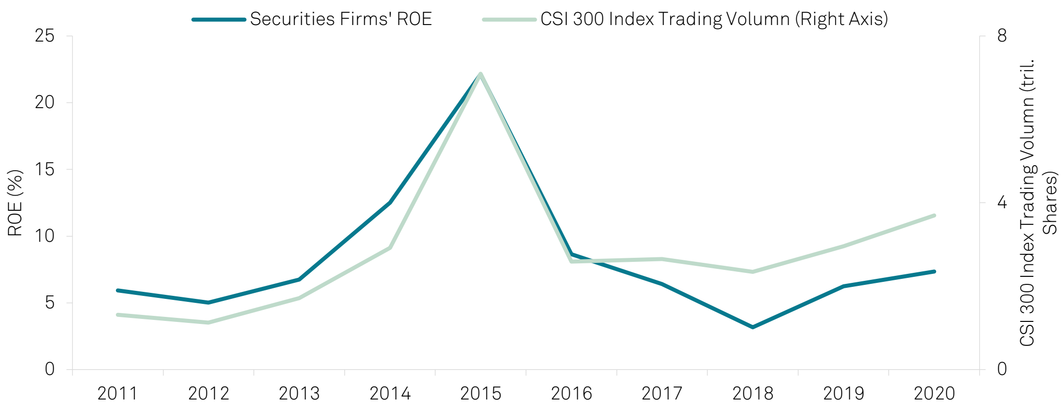
Securities firms' revenue and trading losses are less predictable than banks' net interest income and credit-based losses. Earnings can be very volatile if materially based on market-sensitive revenue. Market risk losses, when they occur, tend to be concentrated (multiple loss positions occurring at once) and unpredictable. Therefore, our earnings assessment focus on not only the absolute earnings level but also earnings volatility through the years.

Performance of all the major business lines of securities firms are highly correlated to the stock market. In addition to investment returns, securities brokerage, investment banking, and other fee income are also related to the performance of the equity market. When the market is bearish, less investors, particularly retail investors, trade, thus affecting brokerage business revenue. Poor stock market performance also affects lending business because more borrowers default and loss given default would be high when prices of collateral stocks drop significantly. In addition, another direct impact is on the performance of proprietary trading activities.

Chart 21

Securities Firms' Earnings are highly Corelated to Stock Market Activity Volume

Domestic Stock Trading Volume and ROE of Listed Securities Firms



Source: Public information of companies, Wind, collected and adjusted by S&P Global (China) Ratings.

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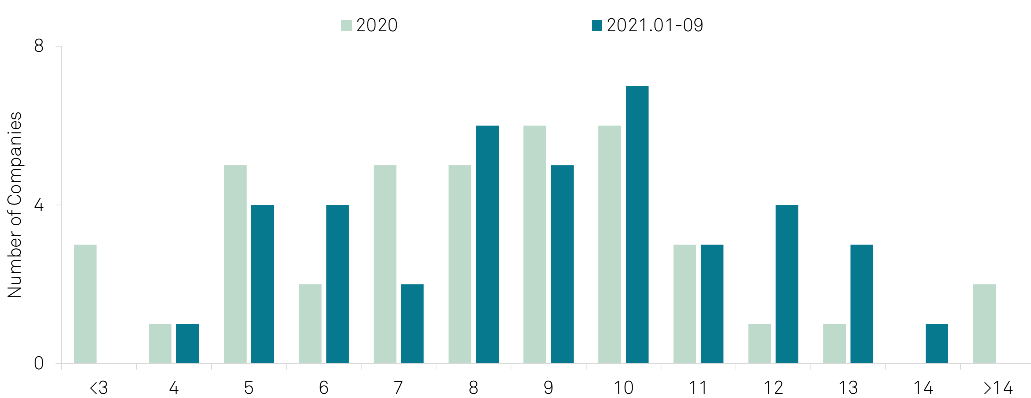
Credit risk in stock-pledged lending business was lower in 2021, leading to much lower credit cost and better earnings. As of September-end 2021, we estimate that the stock-pledged lending book of the 40 listed securities companies was down by about 10% compared with the end of 2020. In 2020, stock-pledged lending had already dropped by 11% YoY. We view the decreasing stock-pledged lending exposure as a positive for credit risk control. Decreasing credit risk exposure has led to less credit cost. In the first three quarters of 2021, the average provisioning/pre-provision profit ratio was only 1.7% for the 40 companies, representing a significant YoY decrease of 10 percentage points. Annualized ROE was 10.4% in the first three quarters of 2021, higher than 8.6% in the same period in 2020.

Chart 22

Securities Firms Enjoy Good Earnings in Recent Years

Distribution of Annualized ROE of 40 Listed Securities Firms in 2020 and 2021.01-09



Note: Data of 2021.01-09 is annualized.

Source: Public information of companies, collected and adjusted by S&P Global (China) Ratings.

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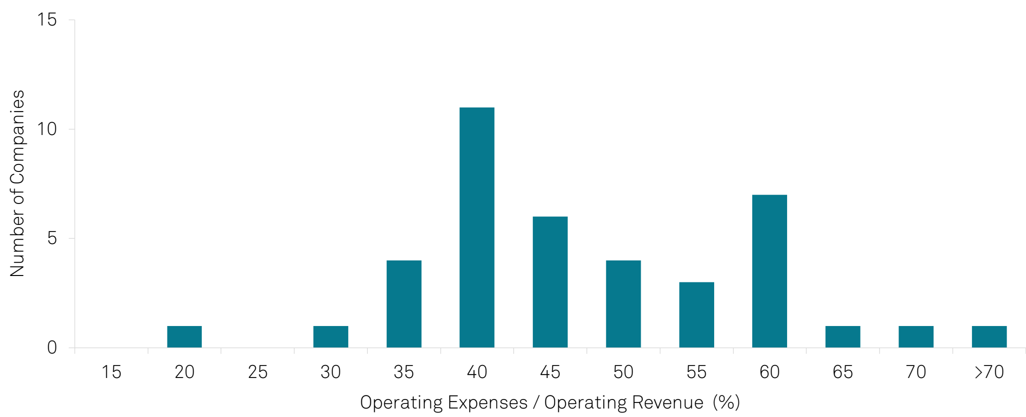
Operating cost, particularly the human capital cost, also has significant impact on the profitability of securities firms. Therefore, we also consider the absolute amount of operating cost as well as the flexibility of reducing operating cost during trying time.

Chart 23

High Operating Cost Affects Some Securities Firms' Profitability

Distribution of Securities Firms' Operating Expenses/Operating Revenue Ratio in 2020



Source: Public information of companies, collected and adjusted by S&P Global (China) Ratings.

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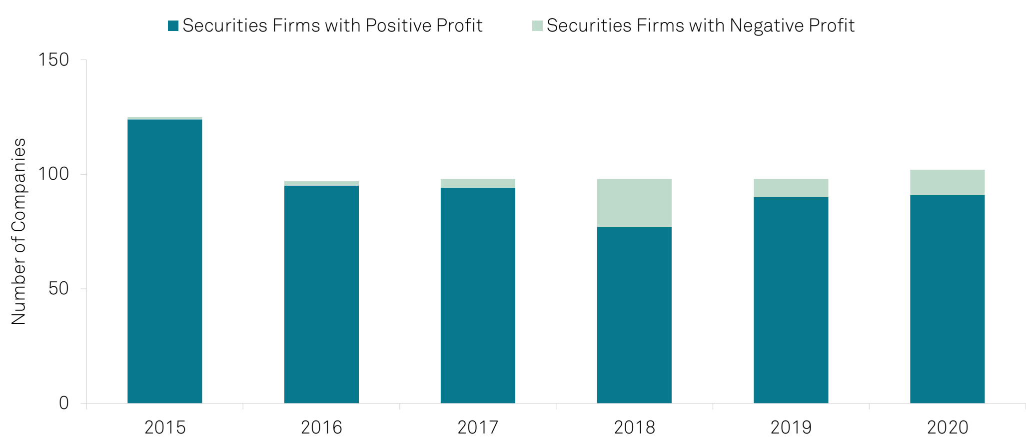
Despite the higher volatility of securities firms, the downside earning risk has been limited due to the sector's low leverage, which significantly limits the degree of maximum losses possible. The five-year earning volatility ratio for 2015-2020 was high, largely because of the 2015 stock market boom that led to very high earnings that year.

Chart 24

Operating Loss Has Been Limited to a Dozen of Small Players

Number of Securities Firms Suffering Negative Earnings from 2015 to 2020



Source: Public information of companies, collected and adjusted by S&P Global (China) Ratings.

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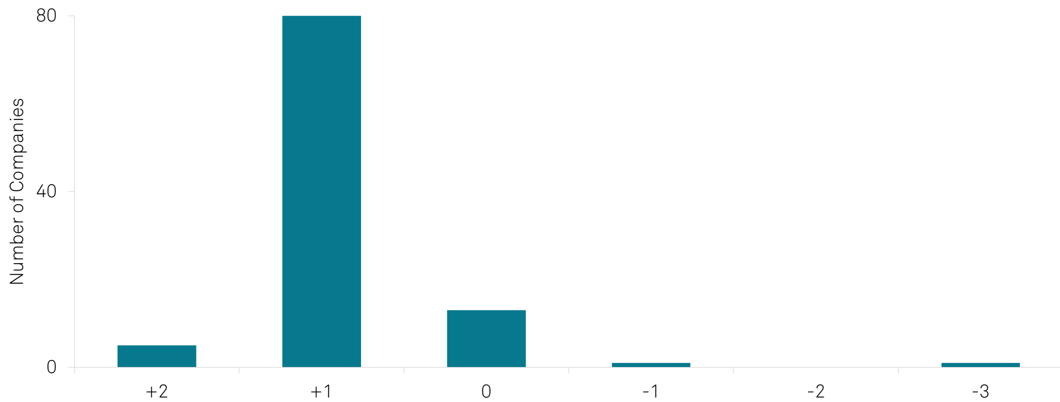
Chart 25

Most Securities Firms Have Strong Capital

Distribution of Indicative Capital and Earnings Notching of 100 Major Securities Firms



Note 1: The notching is applied to the “bbb-” anchor of securities firms as part of the SACP assessment.

Note 2: The indicative notching expressed in this report is S&P China’s indicative views of risk factors derived from a desktop analysis based on public information without interactive review with any particular institution or the full credit rating process such as a rating committee (except for some institutions for which we have assigned ratings on). The opinions expressed herein are not and should not be represented as part of a credit rating.

Source: S&P Global (China) Ratings.

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Risk Position

For securities firms, risk position analysis--the third SACP factor--refines our view of a firm's specific risks beyond the conclusions arising from the capital & earnings analysis. The risk position scale is 1 to 6, score 1 is the best, and score 6 the worst.

Table 7

Risk Position Assessment of Securities Firms

Score	Notching	Typical Profile
1	+2	A firm is able to withstand economic stress significantly better than indicated by the capital & earnings assessment.
2	+1	A firm is able to withstand economic stress somewhat better than indicated by the capital & earnings.
3	0	A firm’s exposure to economic risk is adequately reflected in the capital & earnings assessment.
4	-1	A firm’s exposure to economic risk is higher than that reflected in the capital & earnings assessment.
5	-2	A firm is far less able to withstand economic stress than that indicated by the capital & earnings assessment.
6	-3	A firm’s risk exposure is outsized and substantially in excess of that reflected in the capital & earnings assessment and represents material credit quality weakness.

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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. We also assess the management's risk appetite and positioning, which may increase the likelihood of losses under stressed conditions. We assess the following factors for our risk position analysis:

- **Risk appetite:** This covers growth and changes in exposures;
- **Credit and market risk management;**
- **Concentrations:** The impact of risk concentrations or risk diversification;
- **Complexity:** How increased complexity adds risk; and
- **Loss experience and expectations:** A comparison of past and expected losses on the current mix of business with those of peers and the loss experiences during past economic downturns. Greater-than-average losses may indicate a weaker risk position;
- **Other material risks that are not addressed within our capital & earnings assessment.**

Risk appetite. The higher a firm's risk appetite, the less reliable even recent results or metrics are as a measure of its prospective risk levels, losses, or capital adequacy. To consider how growth and changes in exposure or risk appetite can affect prospective risk, we consider indicators of both the level of and changes in risk appetite, as well as trends in the level and type of risk exposures.

A management's risk appetite is manifested in the trade-offs it is willing to make between profitability and risk, especially during periods of heightened market or credit risk. We consider a firm's risk appetite in the context of our outlook for market and economic conditions and relative to peers. Management that is willing to reduce risk and lower profitability in anticipation of heightened market or credit risk or otherwise challenging business conditions can support a stronger risk position. Management that takes on risk and is unwilling to accept lower profitability or slower organic or acquisitive growth, suggests an aggressive risk appetite and a lower risk position assessment.

Examples of how risk appetite or growth and changes in exposure may increase prospective risk relative to what is captured in the Capital & Earnings analysis, particularly when combined with insufficient risk management capacity, include:

- Showing more aggressive recent organic or acquisitive growth and more significant prospects for future growth than in the past or compared with peers;
- Moving into new product, customer, or market activities outside of its traditional area of expertise;
- Increasing value at risk (“VaR”), trading assets, and trade and underwriting volumes relative to historical levels and peers;
- High volatility of trading profit/loss figures compared with peers;
- Management's stated return/risk objectives, limits, and growth (such as trends in market volumes and portfolio holdings) are higher than peers or are increasing relative to historical levels;
- Frequent or large changes in or breaches of stated risk limits or standards;
- Poor regulatory compliance track record or recent material issues;
- Increasingly offering bridge financings, underwriting more on a committed basis, or otherwise increasing the amount of the firm's capital committed to generate business or otherwise high or 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; and
- Taking on riskier, more marginal clients or supporting riskier client activity.

Examples of risk appetite and growth and changes in exposure that can demonstrate decreasing prospective risk relative to what is captured in the capital & earnings analysis and therefore support a stronger risk position include:

- Reducing or exiting risky activities (for example, acting more as an agent for clients than as a principal in transactions);
- Shrinking total exposure by reducing the amount of or improving the quality of positions;
- Remaining more focused on serving its core customer base with traditional expertise and limiting opportunistic proprietary activities;
- Significant improvement in regulatory compliance performance;

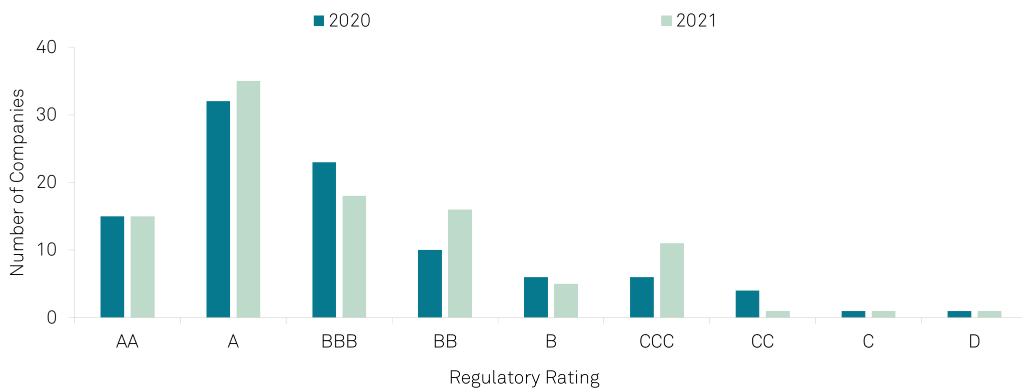
- Keeping to a similar portfolio of risks that limited losses in previous economic or market downturns; and
- Decreasing VaR, trading assets, and trade and underwriting volumes relative to historical levels and peers', which we expect to continue.

We also consider regulatory inspection results when assessing securities firms' risk position. CSRC's regulatory rating results are not credit ratings. They are the regulator's comprehensive assessment of securities firms on their risk governance, internal control, risk management capability and regulatory compliance risk relative to their business profile. Low regulatory ratings or large fluctuations of regulatory ratings may indicate high risk appetite and/or weak risk management capability.

Chart 26

Effective Regulatory Assessment Helps Contain the Industry's Operating Risk

Distribution of Regulatory Ratings of Securities Firms



Note: According to Provisions on the Classified Supervision and Administration of Securities Firms issued by CSRC, the regulatory ratings of Securities Firms are divided into 5 categories and 11 rating levels, including A category (AAA, AA, A), B category (BBB, BB, B), C category (CCC, CC, C), D and E. Regulatory ratings of A to C categories indicate the securities firms remain going concerns. Regulatory ratings of D and E indicate that the securities firm suffers significant risk and may be subject to regulatory interventions.

Sources: CSRC, collected and adjusted by S&P Global (China) Ratings.

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Credit and market risk management. We consider a firm's capacity to manage the principal risks it faces: credit, counterparty, and market risks. We consider whether a securities firm's risk oversight and control capabilities are sufficient for the level, nature, and complexity of its credit and market risk exposures and management's stated risk appetite. We also consider risk managers' authority and oversight and ability to monitor and control limits in real time. Successful credit and market risk management is typically confirmed through loss history that is comparable or superior to peers.

Examples of credit and market risk management deficiencies that could lower the risk position assessment include:

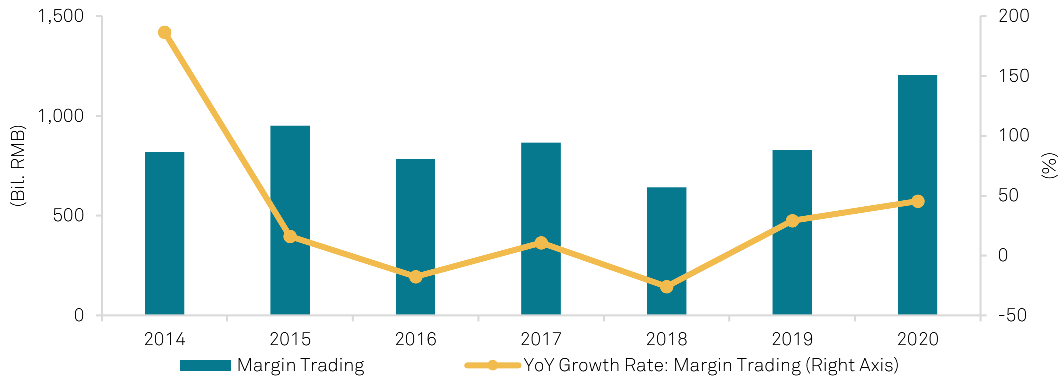
- Incomplete scope or reach of risk-monitoring capabilities;
- Materially large risks or risks that frequently exceed stated risk limitations;
- Undue volatility in VaR, for example, reflective of weaker hedging, including a wide gap between the highest observed VaR and the average VaR in recent periods; and
- Risk limits that frequently change or are outsized on an individual trader or desk basis.

There are typically two types of margin lending business for securities firms in China. One is margin trading, where credit risk is controllable through effective margin management thanks to good granularity and liquidity of the portfolio. As of the end of 2020, the 40 listed securities firms had 1.2 trillion RMB worth of margin trading assets, accounting for 14% of their total assets. Thanks to heightened market activities in 2020, margin trading assets increased by 45% in 2020 YoY. The 40 listed securities companies saw margin trading business rise to 1.36 trillion RMB as of September-end 2021, up 13% compared with the end of 2020.

Chart 27

Size of Margin Trading Business is Correlated with the Stock Market Performance

Changes in Margin Trading Assets of 40 Listed Securities Firms



Sources: Wind, collected and adjusted by S&P Global (China) Ratings.

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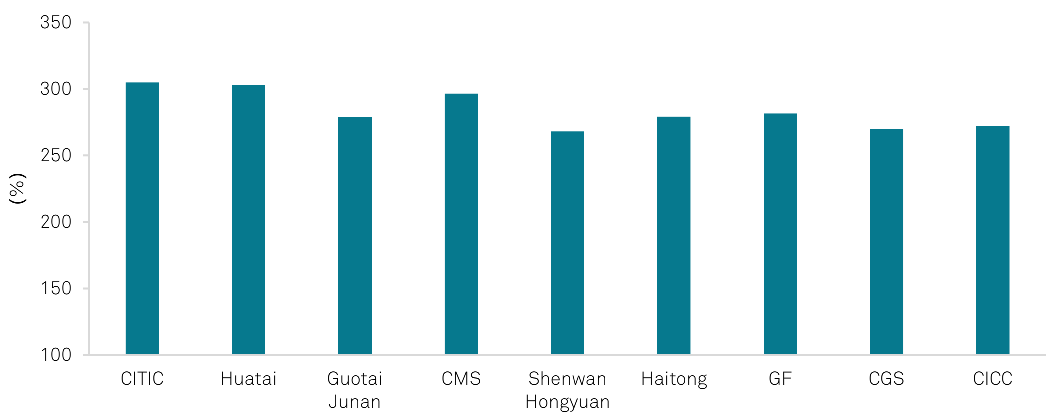
Chart 28

Margin Management of Large Securities Firms are Generally Effective

Average Margin Ratio of Margin Trading of Major Securities Firms as of End of 2020



Note: CITIC-CITIC Securities, CMS-China Merchants Securities, GF-GF Securities, CGS-China Galaxy Securities, CICC-China International Capital Corporation.

Sources: Public information of companies, collected and adjusted by S&P Global (China) Ratings.

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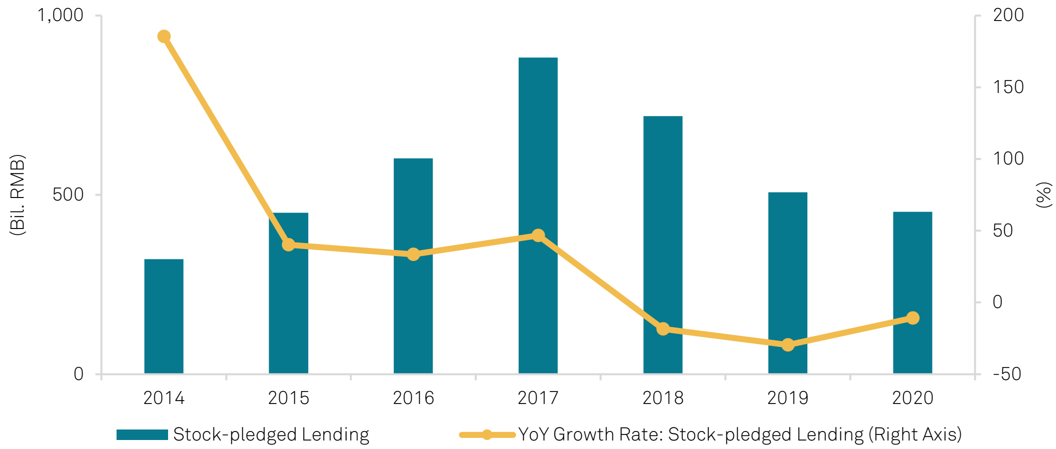
The other kind of margin lending business in China is stock-pledged lending typically to large shareholders of corporates. The risk of stock-pledged lending is harder to control if a corporate's equity rapidly deteriorates in value in a short period of time.

Chinese securities firms' credit risk exposures increased significantly a decade ago due to the expansion of stock-pledged lending business. There have been incidents of large losses from stock-pledged lending due to lumpiness of the portfolio. Nevertheless, we have seen a contraction of risky lending and increased provisioning in recent years. As of the end of 2020, the 40 listed securities firms had 453 billion RMB worth of stock-pledged lending assets, accounting for 5% of their total assets.

Chart 29

Stock-pledged Lending Exposure Decreased in Recent Years

Change of Stock-pledged Lending Assets of 40 Listed Securities Firms



Sources: Wind, collected and adjusted by S&P Global (China) Ratings.

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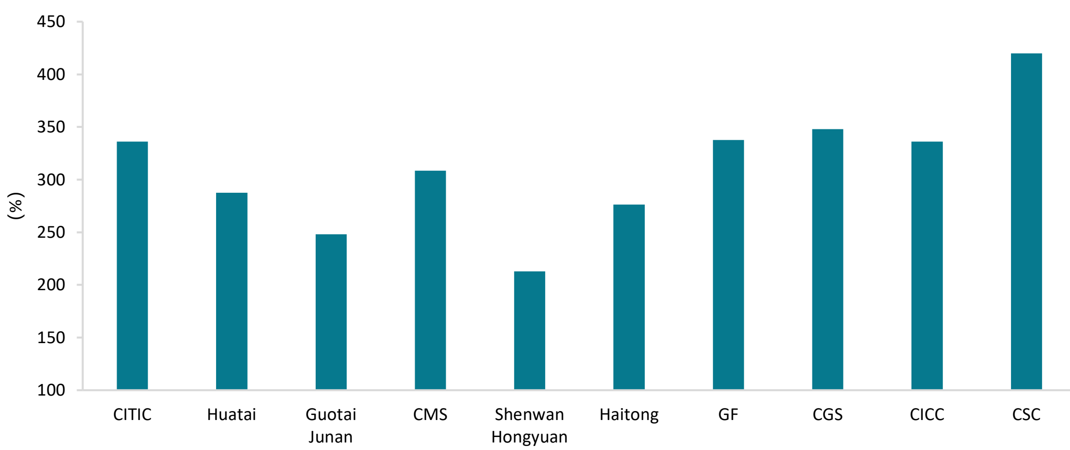
Chart 30

Large Securities Firms have Sound Collateral in Their Stock-pledged Lending Business

Average Margin Ratio of Stock-pledged Lending Business of Major Securities Firms as of End of 2020



Note: CITIC-CITIC Securities, CMS-China Merchants Securities, GF-GF Securities, CGS-China Galaxy Securities, CICC-China International Capital Corporation, CSC-China Securities Corporation.

Sources: Public information of companies, collected and adjusted by S&P Global (China) Ratings.

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Chart 31

Stock-pledged Lending and Margin Trading Shows Different Growth Momentum

YoY Growth Rate in Stock-pledged Lending and Margin Trading Business of 40 Listed Securities Firms and Change of Shanghai Composite Index

Sources: Wind, collected and adjusted by S&P Global (China) Ratings.

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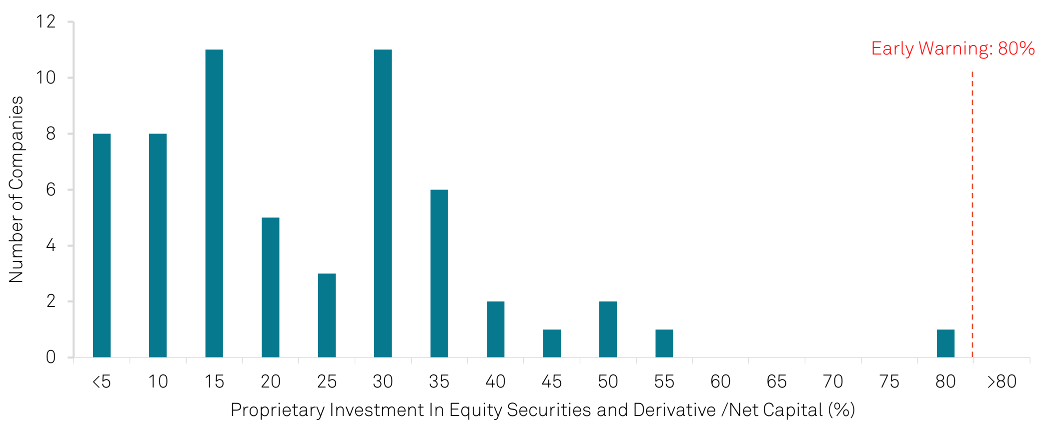
As for market risk assessment, we look at securities firms' proprietary trading portfolios relative to their equity size, and breakdown their investment portfolios in terms of fixed-income investments vs. equity investments.

Risk concentration. Concentration can play an important role for securities firms' loss control. When appropriately managed, diversification of risks appears to lead to lower overall losses compared to less diverse peers. Our analysis of business position captures concentrations in revenue contributions by business line, and uses concentrated earnings sources as an indicator of low-quality earnings. By contrast, our analysis of risk position 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.

Chart 32

Major Securities Firms have Limited Exposure to Equity-related Market Risk

Distribution of Proprietary Investment in Equity Securities and Derivatives/Net Capital Ratio of Major Securities Firms as of End of 2020



Note: The maximum regulatory limit for this ratio is 100%, and early warning is set at 80%.

Sources: Wind, collected and adjusted by S&P Global (China) Ratings.

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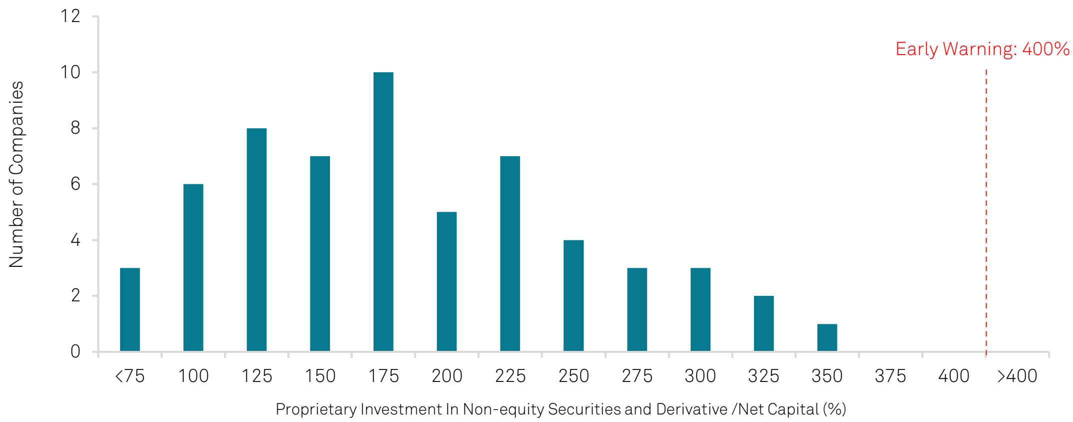
Chart 33

The Industry's Exposure to Fixed Income Products is Well Below Regulatory Limits

Distribution of Proprietary Investment in Non-equity Securities and Derivatives/Net Capital Ratio of Major Securities Firms as of End of 2020



Note: The maximum regulatory limit for this ratio is 500%, and early warning is set at 400%.

Sources: Wind, collected and adjusted by S&P Global (China) Ratings.

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Complexity. Greater scale and diversity of business lines and geography may bring diversity 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 and other exotic products may lead to greater complexity and increased risk. The opposite of complexity is represented by transparent and straightforward risks that are well-understood and well-managed compared with those of peers. Given the CSRC's tight regulatory oversight, we typically believe the majority of Chinese securities firms have similar levels of complexity.

Loss experience and expectations. Loss experience supports the initial risk position assessment considering the following: low recent and low expected losses relative to those of peers and a better-than-average track record of losses during periods of similar economic stress. Loss experience lowers the initial risk position assessment in the presence of losses that exceed the average for peers, or a track record of higher-than-average losses during recent periods of economic stress. Other indications of weaker loss experience and expectations include:

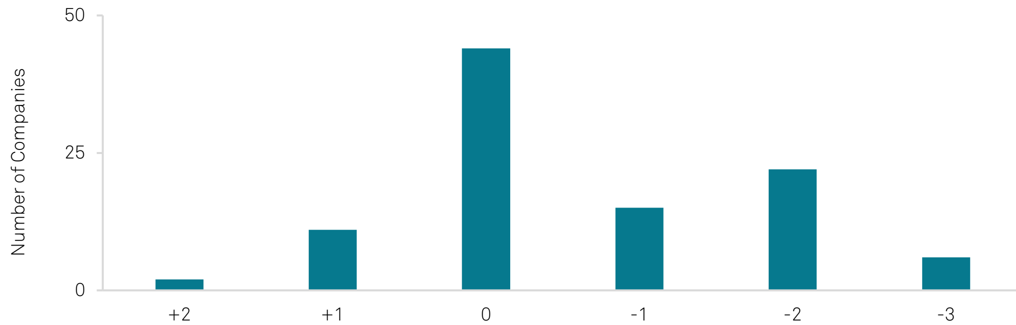
- Credit provisioning and loss recognition that may be more or less aggressive than for peers;
- Volatility in the valuation of the securities portfolio that suggests capital needs may have been underestimated;
- Legal or regulatory costs or fines that are high in an absolute sense, or materially higher than for peers in the same lines of business; and
- Trading losses that are higher than peers.

Other Risk. For securities firms, we may also consider the materiality of additional risk beyond that reflected in the capital & earnings assessment, particularly associated with the trading book, illiquid or hard-to-value securities, and underwriting-related risk. When these represent material additional risk beyond that reflected in the capital & earnings assessment, it would support a lower risk position assessment. One of these risks may also include information risk related to less reliable data.

Chart 34

Risk Position is a Key Risk Differentiator for Securities Firms

Distribution of Indicative Risk Position Notching of 100 Major Securities Firms



Note 1: The notching is applied to the "bbb-" anchor of securities firms as part of SACP assessment.

Note 2: The indicative notching expressed in this report is S&P China's indicative views of risk factors derived from a desktop analysis based on public information without interactive review with any particular institution or the full credit rating process such as a rating committee (except for some institutions for which we have assigned ratings on). The opinions expressed herein are not and should not be represented as part of a credit rating.

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Funding & Liquidity

For securities firms, we assess their funding and their liquidity on an individual basis, before combining both to determine their overall impact (in terms of notching) on the SACP. Funding and liquidity are closely related. Funding focuses on an entity's long-term funding structure, while liquidity analysis focuses primarily on the short term. We use the following matrix to combine our funding assessment and liquidity assessment to arrive at our final notching on funding and liquidity.

Table 8

Combining Funding and Liquidity Assessments to Determine Impact on SACP

Funding	Liquidity				
	1/Strong	2/Adequate-High	3/Adequate-Low	4/Moderate	5/Weak
Above Average	+2/+1	+1/0	-1	-2	-3
Average	0	0	-1	-2	-3
Below Average	-1	-1	-1	-2	-3

Note: When the liquidity score is 5/weak, and we identify a path to default, we may cap the SACP in b category.

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When the funding and liquidity assessment identifies a clear path to default, the company may be rated B_{spc} category. Funding and liquidity analysis assesses material risks stemming from the use of wholesale funding and a firm's position relative to any regulatory funding or liquidity requirements. Our analysis of funding and liquidity is a combination of qualitative and quantitative assessment.

Funding assesses the strength and stability of a securities firm's funding mix relative to its funding needs. 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.

Table 9

Funding Assessment of Securities Firms

Descriptor	Explanation
Above Average	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.
Average	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.
Below Average	Reflects our view that a firm may fund a significant amount of long-term illiquid assets with less stable funding sources, which raises the potential for funding gaps.

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For securities firms, we typically consider its stable funding ratio and the following qualitative factors:

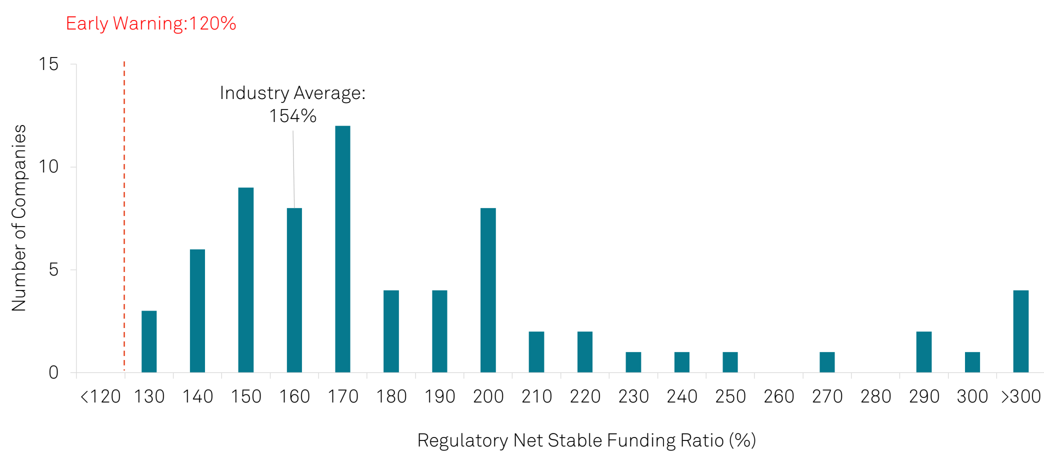
- Currency mismatches;
- Data quality, including whether disclosures are adequate relative to the complexity of a firm's funding risk;
- A firm's position relative to any regulatory funding requirements or standards;
- The extent to which asset encumbrance constrains funding flexibility;
- The stability and maturity of funding sources;
- The quality of stable funding, including diversification and concentrations;
- The analysis of material contractual investment or funding commitments; and
- The presence of a large prime brokerage or derivative business.

The regulator has rigorous regulations on funding stability. The minimum regulatory net stable funding ratio requirement is set at 100% and the early warning trigger is set at 120%. As of the end of 2020, the industry average ratio was 154%, well above the minimum regulatory requirement. The ratio is typically calculated on a daily basis and sent to the regulator on a monthly basis.

Chart 35

Securities Industry Has Comfortable Funding Stability

Distribution of Regulatory Net Stable Funding Ratios of 100 Major Securities Firms as of End of 2020



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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. The liquidity analysis includes assessing the potential liquidity demands relative to liquidity sources. Key factors we look into include on-balance-sheet liquidity, and management of off-balance-sheet and stressed liquidity risks.

Table 10

Liquidity Assessment of Securities Firms

Score	Descriptor	Typical Profiles
1	**Strong**	Reflects our view that a firm is well prepared to meet liquidity demands under stressful market conditions for at least 12 months.
2	**Adequate-high**	Reflects our view that a firm should have capacity to meet its needs under stressful market conditions for at least 12 months.
3	**Adequate – low**	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.
4	**Moderate**	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.
5	**Weak**	Reflects our view that a firm's liquidity is vulnerable under normal market conditions.

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For securities firms, we may consider the following qualitative factors for the liquidity assessment:

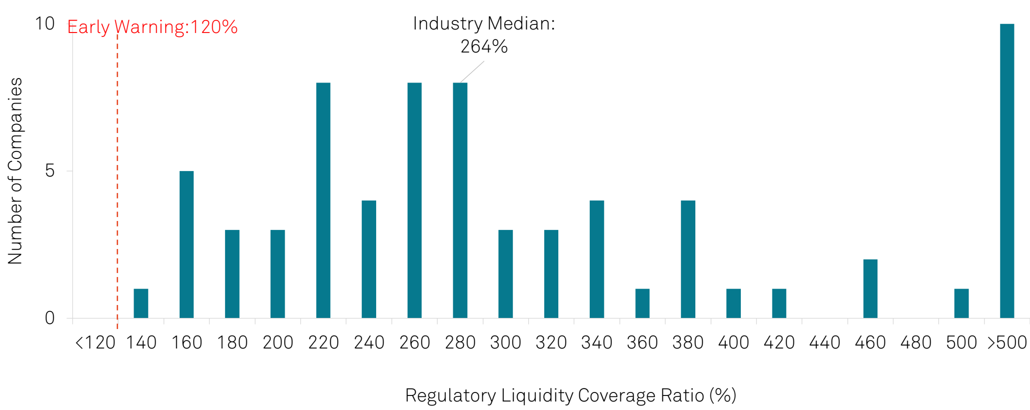
- A firm's position relative to regulatory liquidity requirements or standards;
- Material liquidity mismatches or undue concentrations;
- Fungibility or barriers to intra-group movements of liquidity across a firm's entities;
- Exposure to additional liquidity risk from customers; and
- Management of off-balance-sheet and stressed liquidity risks, including the scope and complexity of contingent liquidity demands from: derivatives or prime brokerage businesses that require excess liquidity or access to additional external liquidity, and the firm's potential stress liquidity needs including collateral and margin calls relative to its available unencumbered liquidity.

Liquidity coverage ratio focuses more on the company's ability to cover expected short-term cash outflow. The minimum regulatory liquidity coverage ratio requirement is set at 100% and the early warning trigger is set at 120%. As of the end of 2020, the median regulatory liquidity coverage ratio was 264%, well above the minimum regulatory requirement.

Chart 36

Securities Industry Have Good Liquidity Coverage

Distribution of Regulatory Liquidity Coverage Ratio of Major Securities Firms as of End of 2020



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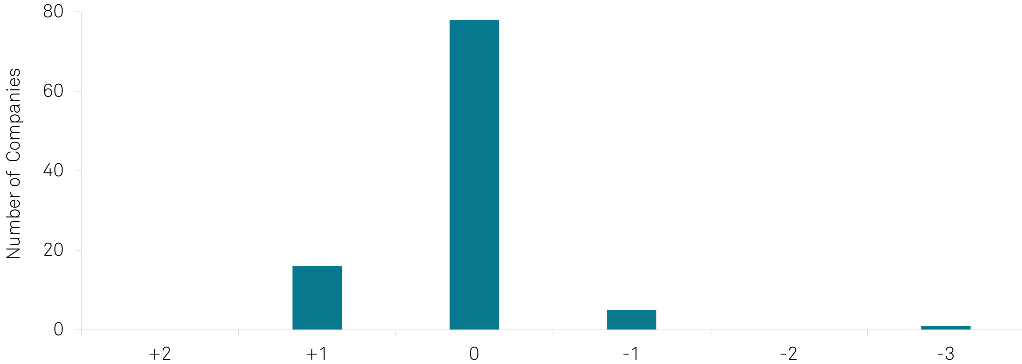
Despite the reliance on wholesale funding, China's securities industry has a sound funding and liquidity profile for the following reasons:

- The assets of securities firms have good liquidity.
- The industry has a low leverage ratio.
- Securities firms have stable access to funding from China Securities Finance Corp. Ltd., a state body that provides margin financing to securities firms in China.
- Strong securities firms also have stable access to bank credit lines.

Chart 37

We Expect Liquidity Profiles of Most Securities Firms to Remain Adequate

Distribution of Indicative Funding & Liquidity Notching of 100 Major Securities Firms



Note 1: The notching is applied to the "bbb-" anchor of securities firms as part of the SACP assessment.

Note 2: The indicative notching expressed in this report is S&P China's indicative views of risk factors derived from a desktop analysis based on public information without interactive review with any particular institution or the full credit rating process such as a rating committee (except for some institutions for which we have assigned ratings on). The opinions expressed herein are not and should not be represented as part of a credit rating.

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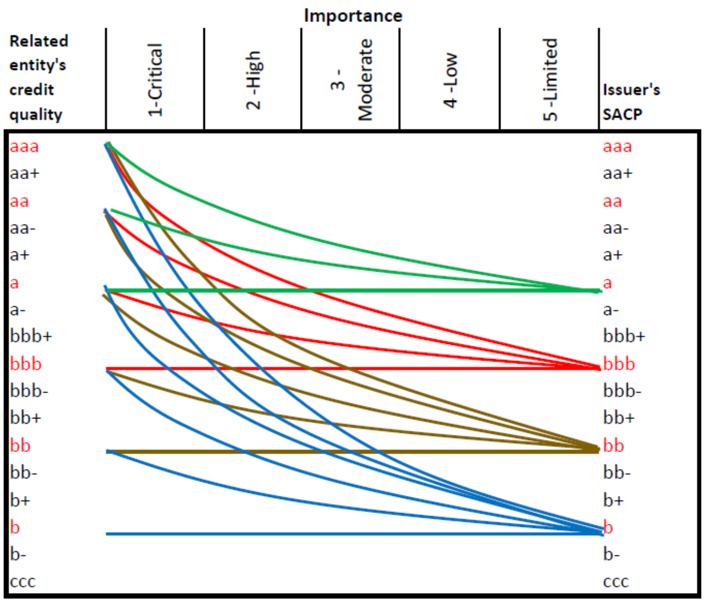
External Support

Our assessment of securities firm creditworthiness typically considers the possibility of government or group support in times of stress. We have a five-point scale to assess a securities firm's importance to government or group. The analytical framework which we use to analyze external support to securities firms is consistent with the framework for banks and other financial institutions.

Chart 38

Our Assessment of Securities Firm Creditworthiness Typically Considers the Possibility of Government or Group Support

Demonstration of Support Assessment Framework



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Among all Chinese financial institutions, securities firms may have the highest degree of market-oriented operations. In previous decades, the number of securities firms which were taken over or liquidated or failed in other ways was much higher than the number of failed commercial banks. Compared to banks, we believe securities firms pose less of a systemic risk because they have lower contagion risk. They typically have limited borrowing in the capital market and their borrowing from each other is also limited. The current regulatory framework separates clients' money from that of the securities firm, which minimizes the social impact of any securities firm failure. In addition, there are many competing securities firms in the market, more or less rendering all of them replaceable. Therefore, we typically don't view securities firms as "critical" to the central government.

In the past few decades, the relatively high risk of securities firms' business models led to frequent problems, including payment difficulties and compliance infractions. The government's approach toward troubled securities firms has varied. Some securities firms were saved by the government, some were dissolved, some were taken over by regulator, and some were merged into other securities firms.

Nevertheless, considering the leading role played by securities firms in efforts to cut out intermediaries in the financial sector and deepen reform of China's capital market, we believe the securities industry is strategically important to the government. In addition, there have been actual cases when the government has bailed out securities firms in crisis. Therefore, government support is also considered in our assessment of securities firms but to a lesser degree when compared to banks. Among the 200 banks we tested, we believe 80% of them would receive government support, while among the 100 major securities firms we tested, we give government support notching to about 40% of them. In our view, central government support is possible in times of stress for leading state-owned nationwide securities firms given their importance to financial stability. We believe regional state-owned securities firms may also be able to receive local and regional government support, because of the strong link between the governments and securities firms.

Chart 39

We Believe Government Support is Likely for Large State-owned Securities firms

Breakdown of Indicative Government Support Assessment of 100 Major Securities firms Tested

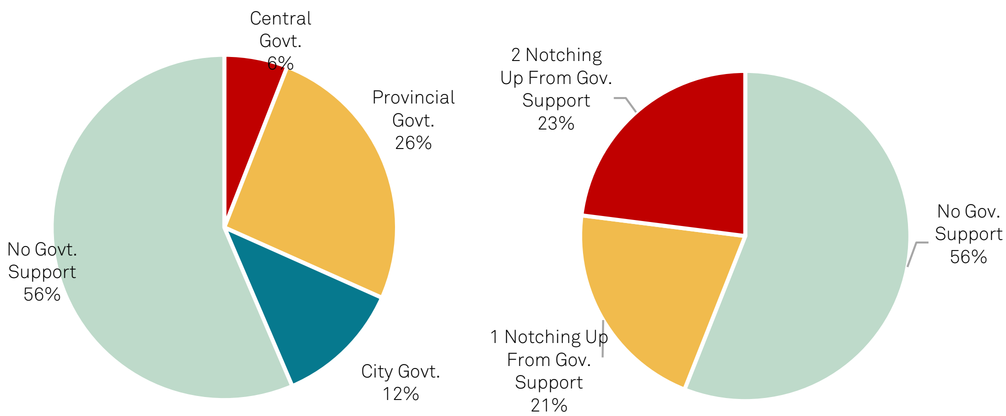

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Table 11

Our Views on the Importance of Securities Firms to Governments

Government	Our Views on Importance Level of Securities Firms to the Government
Central Government	In our view, only a few leading nationwide securities firms may receive extraordinary support from the central government. Typically, we don't believe any securities firm has "1/critical" importance to the central government. Nevertheless, given the financial disintermediation trend in China and the continuous deepening of China's capital market, and also considering the strategic roles played by leading securities firms in this process, we typically believe the largest and best state-owned securities firms are likely to have "2/high" importance to the central government.
Provincial and City Government	Securities firms typically operate at the national level, therefore, the failure of any regional securities firm would not negatively affect that region's access to the capital market because any void in the market would be quickly filled by other securities firms. Therefore, we typically don't believe any regional securities firm would have "1/critical" importance to the regional government. Nevertheless, if a securities firm has clear ties with a regional government in terms of ownership and appointment of management, we may believe it has a "2/high", "3/moderate" or "4/low" level of importance to the regional government. Other factors we consider when deciding on a regional securities firm's importance level to a regional government include the number of regional securities firms operating in the region, the business franchise of the securities firm, the contribution the securities firm makes in terms of providing

	local enterprises with access to the capital market, the track record of a regional government bailing out its regional securities firms, and whether a region positions itself as a financial center. For example, we may believe the state-owned top securities firm in Shanghai has “2/high” importance to Shanghai Government given Shanghai’s status as a major financial center. In comparison, the importance level of a regional securities firm to a city which doesn’t consider itself a financial center may be “3/moderate” or lower.

Note: This table is only the starting point for our analysis, and if an institution has idiosyncratic characteristics, our final assessment may be different from what is indicated in the table.

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Table 12

Starting Point for Preliminary Assessment of Securities Firms’ Importance to the Government

<table>
<tr><th colspan="2">Importance Level for Governments</th></tr>
<tr><td>1/Critical</td><td>Typically, we believe state-owned mega banks are critical to the central government, and in comparison, any securities firm failure has less of an impact on China’s financial and social stability. Therefore, we typically don’t put securities firms into “1/critical” level in terms of importance to the central government.</td></tr>
<tr><td>2/High</td><td>In our view, state-owned leading securities firms have “2/high” importance level to the central government given their role in maintaining capital market stability. For important financial centers, such as Shanghai and Beijing, we believe their leading securities firms have “2/high” importance to their respective regional governments given their important role in supporting the cities’ status as financial centers.</td></tr>
<tr><td>3/Moderate</td><td rowspan="2">In our view, state-owned regional securities firms typically have “3/moderate” or “4/low” importance level to the regional/local governments because of the strong link between the government and the securities firm. We believe the regional/local government might see value in owning a securities firm, particularly when the region only has one state-owned regional securities firm. But given the national nature of brokerage and investment-banking business, a failure of a regional securities firm typically won’t affect the region’s access to the capital market and won’t lead to a dearth of services for clients.</td></tr>
<tr><td>4/Low</td></tr>
<tr><td>5/Limited</td><td>Small private-owned securities firms whose failure would have a very limited impact on the capital market.</td></tr>
</table>

Note: This table is only the starting point for our analysis, and if an institution has idiosyncratic characteristics, our final assessment may be different from what is indicated in the table.

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About 22% of the securities firms we tested may receive group support in times of need. Generally speaking, our approach to assessing securities firms’ group support is consistent with our approaches for banks and other financial institutions. Key factors to consider when assessing the importance of a securities firm subsidiary to the parent group include the following:

- Whether the subsidiary has strategic importance to the group, how close it is to the development of the core business of the parent group;
- Regulatory position on the group-subsidiary relationship, in terms of intra-group support or risk isolation;
- Contractual requirement of the group to support the subsidiary;
- Size of the subsidiary, and position of the subsidiary within its sector;
- Normalized profitability of the subsidiary through the credit cycle, and subsidiary’s contribution to the earnings of the group;
- Shareholding structure of the subsidiary;
- Name association and logo sharing between the group and the subsidiary;
- Level of operational integration, whether the subsidiary is run more like a department/branch or as an independent entity; and
- Management control and corporate governance by the group.

Table 13

Assessment of Securities Firms' Importance to Parent Group

Securities Firm's Importance Level for the Parent Group	
1/Critical	Majority-owned subsidiaries with name association and strong management ties. The group is typically a financial group within which securities business has very high strategical importance. The securities business contributes significantly to the group's assets, revenue and profits.
2/High	Majority-owned subsidiaries with name association and strong management ties. The group is typically a financial group within which securities business has high strategical importance.
3/Moderate	Majority-owned subsidiaries with strong management ties. The group is typically a corporate group. The securities business is in line with the overall business strategy of the parent group, but securities business may not be the core business of the corporate group.
4/Low	The group may be the largest shareholder, but not the majority shareholder. There are management ties, leading to a possibility of group support.
5/Limit	Very low possibility of support or high uncertainty of the relationship between the securities firm and the group.

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Hybrid Instruments Issued by Securities Firms

Chinese securities firms are regulated by CSRC, and banks come under the oversight of CBIRC. Therefore, securities firms' hybrid bonds tend to have different terms and conditions than banks. Securities firms issue both subordinated bonds (as a liability item on the balance sheet) and subordinated perpetual bonds (as equity items on the balance sheet). A hypothetical example is given below to demonstrate how we rate the hybrid instruments of securities firms.

Table 14

Example of Probable Hybrid Bond Rating Results of a Securities Firm

	Probable Issuer / Issue Rating	Rationale/Comments
SACP	a_{spc}	A hypothetical result only for demonstration purpose
Government Support	+2 notches	A hypothetical result only for demonstration purpose
ICR	AA_{spc}-	The combination of SACP and government support
Senior Unsecured Bond	AA_{spc}-	Same as ICR since it is senior debt
Subordinated Bond		
Starting Point for Notching Adjustment	ICR (AA_{spc}-)	We use ICR as the starting point if we believe external support is available for subordinated bonds of securities firms. Otherwise, we would choose SACP as the starting point.
Standard Notching	-1 notch	One downward notch from ICR to reflect the subordination clause.
Additional Notching	None	There is no additional notching because we believe the securities firm has sufficient capital and the standard notching fully reflects the credit quality of the bond.
Issue Rating	A_{spc}+	One notch down from ICR to reflect the subordination clause. If we believe the instrument does not have government support, the issue rating would be A_{spc}-.
Subordinated Perpetual Bond		

	Probable Issuer / Issue Rating	Rationale/Comments
Starting Point for Notching Adjustment	SACP (a_{spc})	We use SACP as the starting point because we believe government support is not available for the perpetual bonds of securities firms, which have high capital contents.
Standard Notching	-2 notches	Two downward notches from SACP to reflect: 1) subordination clause, 2) coupon deferral clause.
Additional Notching	None	There is no additional notching because we believe the securities firm has sufficient capital and the standard notching fully reflects the credit quality of the instrument.
Issue Rating	$BBB_{spc}+$	Two notches down from SACP to reflect the 1) subordination clause and 2) coupon deferral clause in the prospectus, as well as the high capital contents which are unlikely to enjoy government support.

Note: The notching example is based on the terms and conditions of bonds now issued in the market. If any instrument has different terms and conditions, even if it is called the same name in our example, it would typically lead to different notching results.

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This desktop analysis has been conducted using publicly available information only and is based on S&P China's methodology for financial institutions and our understanding of both the securities industry in China as well as our understanding of the institutions themselves. The analysis involves applying our methodology to public information to arrive at a potential view of credit quality across the securities sector. It is important to note that the opinions expressed in this report are based on public information and are not based on any interactive rating exercise with any particular institution. However, where we have conducted an interactive rating with a specific issuer, our insights and analysis learned from that review with those issuers, may have also been incorporated in our results contained herein. The opinions expressed herein are not and should not be represented as a credit rating and should not be taken as an indication of a final credit rating of any particular institution but are initial insights of potential credit quality based on the analysis conducted. This desktop analysis does not involve any surveillance. The opinions expressed herein are not and should not be viewed as recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security.

We have conducted this desktop analysis on individual institutions and present the results contained herein at an aggregate group level by types of institutions. The different sections of this research show the statistics and performance of different groups of institutions and the market more broadly against the metrics we generally consider most relevant under our methodology.

Given the desktop nature of this analysis, and that we have not conducted an interactive review with most of those institutions, we may have made certain assumptions in lieu of confirmed information and where relevant we may also have attempted to consider any possibility of parent, group, government or other forms of potential support, to inform our view of potential credit quality. S&P China is not responsible for any losses caused by reliance on the content of this desktop analysis.

This report does not constitute a rating action.

Appendix: Related Methodologies and Research

- S&P Global (China) Ratings Financial Institutions Methodology
- Commentary: Understanding S&P Global (China) Ratings Financial Institutions Methodology
- Commentary: Understanding S&P Global (China) Ratings Approach to Support
- S&P Global (China) Ratings – General Considerations on Rating Modifiers And Relative Ranking
- Understanding S&P Global (China) Ratings General Considerations on Rating Modifiers and Relative Ranking Methodology
- Government Support Underpins Financial Stability in China but Doesn't Equal Implicit Government Guarantee for Individual Institutions | Assessing Government Support for Financial Institutions in China
- Rating Approach on Hybrid Bonds Issued by Chinese Financial Institutions

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