Article Title: ARCHIVE | Criteria | Financial Institutions | Broker-Dealers: Rating Securities Companies Data: The future of the securities industry is one characterized by cyclicality, change, consolidation, and complexity. Firms that understand and manage these forces to their competitive advantage are the best equipped to survive long term. Within the securities industry are two basic distribution channels: institutional and retail. The forces influencing performance, financial profile, and competitive dynamics differ for the two types of firms. As a group, securities firms are essential to the functioning of capital markets, allowing buyers and sellers to find common prices either through exchanges or over-the-counter transactions and bringing new issuers into the capital markets. They aid the liquidity of markets by providing financing for securities positions and facilitate transfers of collateral needed to allow short sale of securities. Their operational capabilities help the smooth clearance of securities transactions. Expertise in valuing businesses leads to advisory assignments. Standard & Poor's securities firm ratings take into account business risks, the strength of a franchise as indicated by performance, diversity, capital strength, liquidity management, and other factors. Cyclicality Standard & Poor's ratings reflect a long-term default risk. These ratings are meant to take into account a normal cycle in an industry and, thus, change only minimally, if at all, as an industry goes through the trough of the economic or other cycles it faces. This philosophy is illustrated by the stability of securities firms' ratings, which generally do not change through the ups and downs of the industry. For the securities firms, to rate through a cycle means that the ratings depend on particular judgments about a "normal" cycle and about markets, industry structure, and securities firms themselves. Where most other industries face fairly predictable cycles of falling volumes and gradual inventory adjustment, securities firms face cycles that often include both sharp declines in prices and decreasing business volumes. In addition, no two cycles in the securities industry are alike, and Standard & Poor's continuously reviews whether cyclical downturns trigger changes in markets, industry structure, or securities firms' adaptability that call into question industrywide ratings. During the past decade and a half, there have been several cyclical downturns that the industry suffered, and the shape and duration of all of them were different. In many cases, cyclically low volumes of business exposed the shoals of merchant banking or aged inventory or other problem assets. While it is impossible to predict the shape of the next cycle, it is certain that cycles will occur and that they will be accompanied by illiquidity in some major markets. A factor that exacerbates cycles in the securities industry is that the seeds of destruction are sown when the climate for the industry is sunny: positions get large; employment bulges; caution about new geographic and product markets evaporates. The extent of leveraging expands rapidly, until some of the participants in the markets disappear. Liquidity then evaporates. Normal correlations between markets shift, destroying hedge ratios. Market prices tend to overshoot both on the way down and on the way up. Still, capital markets are resilient in the sense that trading continues. The result of the cyclicality in the industry is that ratings for securities firms tend to be lower than those of the strongest commercial banks, despite the very strong competitive positions of the largest securities firms. While U.S. commercial banks do not dominate global lending markets, U.S. securities firms have deep global penetration of capital markets. In addition the ratings are supported by the firms' diversity, ability to reduce variable expenses, the generally liquid nature of the balance sheet, and maintenance of contingency plans to deal with "runs" on short-term unsecured funding. Change Securities firms have ridden a wave of change in the capital markets. Change has been spurred by technology, disintermediation, demographics, and regulation. The consequence of external and internal change has been the growth in the number and size of competitors. As the capital markets around the world continue to develop, the need for capital size becomes more acute. At the same time, European universal banks are putting more capital into their capital markets activities. Still, it takes more than capital to compete in capital markets. While the barriers to entry are low, the barriers to success—that is, sustainable, profitable, and long-term customer relationships—are high. Change has also engendered the globalization of capital markets. Given the increasing technological capabilities of moving money and information across borders, intermediaries need to be able to serve the cross-border demands of issuers and investors. The global infrastructure increases fixed expenses, but successful global penetration should lead to greater diversification and more stable revenues. There are increased risks that many different markets will fall in tandem in the short term, but the major individual markets will usually return to normal trading volumes to the degree that economic and monetary fundamentals are sound. A key risk is the reversal of liberalization of capital flows, which would undermine the fundamentals. Another risk would be the reversal of the global trend toward pension plans, which give individual investors increased control over their retirement wealth. Complexity Change leads to complexity. Securities firms have expanded into a host of new businesses, some of which did not exist a few years ago. In addition, geographic expansion makes managing a securities firm more complex. The product expansion that probably carries the most risk is the extension of unsecured credit. Traditionally, securities firms extended credit only when it was secured by a marketable security. Such credit supported trading for customers. Any decline in the value of the security had to be remedied through a margin call, so the broker did not face unsecured credit risk, unless the customer failed to meet the margin call. With the development of interest rate swaps and other over-the-counter derivatives, securities firms began to take long-dated unsecured credit risk. During ebullient market periods, competitive pressures led firms to offer "bridge" loans, or unsecured loans that would be repaid through the issuance of high-yield securities. Securities firms' high-yield trading desks began managing larger and larger positions. As the line between commercial banks and brokers blurred, the securities firms entered the syndicated lending business. Managing unsecured credit risk is difficult even for commercial banks. In the case of derivatives, the potential credit risk may be many times the size of the current credit risk. Credit risk management requires continuous surveillance of the many different names in a credit portfolio. Market risk management also has become more complicated. Derivative markets allow customers to take risks that they might not normally be able to take. They also allow proprietary trading desks to take bets on volatility or on movements between seemingly unrelated asset classes. Some U.S. securities firms have operations in so many different geographic and product markets that it has become more difficult to manage the organizations. Consolidation Consolidation has occurred in waves in this industry. Consolidation in the early 1980s was based on emergent demand for capital market instruments, as well as the huge debt issuance of the U.S. government, both of which fueled growth of the over-the-counter markets and the need for trading capital. There was a jostling among competitors to acquire the necessary skills to become broader-based competitors. Consolidation has also accompanied cycles where initially weaker players fell into the hands of their competitors, as did E.F. Hutton. Internationally, consolidation was triggered by major policy changes, like the "Big Bang" in London. In the mid-1990s, consolidation was triggered by regulatory change. The U.S. Federal Reserve Board decided to liberalize affiliation between commercial banks and securities firms. The move set off a scramble for both intra- and interindustry combinations. As commercial banks put additional capital into the securities markets, the increased competition will likely sustain continuing consolidation. The good news for the consolidators is that securities firms' balance sheets are marked-to-market on a daily basis and are made up of readily salable positions for the most part. The bad news for consolidators is that buying an existing franchise is very risky, because by integrating a target firm, an acquirer can very easily lose many of the key people they need to keep.