



ICRA Rating Feature

Rating Methodology for Entities in the Brokerage Industry

The Rating Methodology for Entities in the Brokerage Industry, January 2018 updates and supersedes ICRA's earlier methodology note on the industry, published in January 2010.

Overview

Stock Brokerage Houses (henceforth referred to as 'brokers' or 'brokerage firms') perform an important role in the capital market by facilitating trade for all categories of investors. The role of intermediaries such as brokers is critical in developing a capital market structure that is fair and stable, while providing adequate liquidity to the market. As the Indian equity broking industry is highly fragmented—with more than 32,000 brokers and sub-brokers active on various exchange houses—investors have a large number of intermediaries at their disposal for undertaking transactions on exchange houses. The Indian stock brokerage industry is also very dynamic and volatile as it is dependent on the capital market. For instance, brokerage firms witnessed one of the worst phases in FY2009, which exposed their vulnerability to various business risks associated with equity broking. Similarly, brokerage firms witnessed a lull in FY2016 after a period of heady traction in the earlier fiscal. A key industry trend in the past decade has been the emergence of discount brokerage houses, which have caused sharp contraction in broking yields and consequently shrunk the profitability levels of the industry.

ICRA's rating methodology for entities in the brokerage industry focuses on key operational, financial and qualitative factors that ICRA believes to be most critical in assessing an entity's overall performance, competitive positioning and its ability to withstand challenging operating environment and service its debt obligations. ICRA also assesses the entity's management based on the competence and quality, risk appetite, and financial policies. ICRA notes that analysis of financial ratios alone (based on annual reports) does not capture all risks associated with a brokerage firm. For the rating of a brokerage firm, ICRA also considers other group companies engaged in various capital market related business activities, such as commodity broking, investment banking, wealth management and distribution of financial products, given the strong linkages and operational synergies between these operations. While ICRA evaluates a brokerage firm's performance against all these critical factors before assigning the final rating, special emphasis may be placed on some of them, depending on the operating profile of the broker being rated and the nature of the instrument.

This rating methodology document is not intended to provide an exhaustive list of all factors reflected in ICRA's ratings, but it should enable lenders, investors and market participants to understand the rating considerations that are usually the most important. For analytical convenience, the key factors are grouped under the following broad heads, namely, Industry Risk, Management and Governance Quality, Business Risk and Financial Risk.

- **Industry Risk**
- **Management and Governance Quality**
 - Promoters Experience and Track-record
 - Stability and Experience of Top Management
 - Corporate Governance
 - Accounting Quality
 - Regulatory Compliance

▪ Business Risk

- Operational Assessment
 - a) Diversification of Business Revenues
 - b) Competitive Position Across Segments
 - c) Client Quality and Diversification
- Business Infrastructure
 - a) Robustness of IT System
 - b) Adequacy of Management Information System
 - c) Strength of Back Office Operations
- Risk Management
 - a) Risk Governance
 - b) Management of Market Risks
 - c) Management of Credit Risks
 - d) Management of Operational Risks

▪ Financial Risk

- Earning Strength and Stability
- Asset Quality
- Capitalisation and Liquidity Management

Industry Risk

A brokerage firm's performance is closely linked to the domestic capital market, which in turn is exposed to various macro and micro factors. The broking industry is highly dynamic and unpredictable given the volatility inherent in the capital market. Thus, for evaluating the overall credit profile of a broker, an assessment of the industry or the operating environment remains critical. A key parameter for this assessment is the market dynamics, which captures the favourability of operating environment for capital market related business operations. A conducive capital market environment, which is characterised by increasing industry brokerage turnover, rising indices levels, growing number of initial public offers (IPOs) and investment banking deals, is expected to help a brokerage firm improve its financial performance while keeping associated risks low. On the other hand, unfavourable capital market with declining brokerage turnover, highly volatile stock prices would not only impact the entity's operating performance but also its financial profile as it could lead to concerns on its own capital due to credit risk and market risk associated with the brokerage business. This notwithstanding, ICRA's ratings of brokerage firms do not necessarily change as the state of the capital markets change, but duly incorporate the inherent volatility-induced industry risks. The regulatory environment also plays a key role as any material change in regulations¹ can also have a bearing on credit rating of the brokerage houses. Additionally, the competitive intensity in the industry can have a deep impact on brokerage house's financial and operating strategy as well as on its current and future profitability. Intense competition puts pressure on a company's profitability margins and requires constant innovation for maintaining its margins. The Indian equity broking industry in particular is highly fragmented with more than 32,000 brokers and sub-brokers active in the market. Furthermore, the emergence of discount brokerage houses has disrupted the industry dynamics with a steep correction in brokerage yields in the past decade. While businesses such as retail broking and arbitrage trading are highly fragmented, other activities such as institutional broking, investment banking, distribution, and also capital market related funding are limited to few large and established entities.

¹ In November 2015, in a bid to contain retail participation in the futures & options (F&O) or derivatives segment turnover, SEBI increased the minimum contract size for contracts to Rs. 5 lakh from Rs. 2 lakh. This resulted in a decline in trading volumes in the following months as participants adjusted their trading strategies to comply with the new regulations.

Management and Governance Quality

In light of the dynamic nature of domestic capital market, the quality of management is of utmost importance to ICRA's framework of assessing brokerage firm's rating. While it is easy for the brokerage firms to scale up their business operations during the boom in capital market, in ICRA's view, the quality of management remains imperative for tiding over stressful times. ICRA assesses the management quality on the following factors:

Promoters Experience and Track-Record

ICRA's framework involves reviewing the promoter's track record in terms of business growth, risk appetite, gearing, liquidity policy and transparency in running its operations. The promoter group's prior track-record, commitment to the business along with the financial support extended to the venture in distressful times is also considered. Conservative business growth, with no history of litigations or regulatory fines, would be viewed favourably by ICRA over an aggressive business growth with a track-record of regulatory violations. Furthermore, companies backed by strong institutions as strategic investors are expected to have adequate internal controls and processes and thus are expected to provide higher comfort as compared with other companies which are backed by individual promoters.

Stability and Experience of Top Management

ICRA's framework evaluates the stability of the top management, the managers' experience in capital market business operations and their track record to successfully respond to changes in industry dynamics. A brokerage house with a proven track record of managing the business efficiently through various business cycles, professional management structure, good market reputation and history of fair practices is viewed favourably by ICRA.

Corporate Governance

ICRA's analysis of corporate governance practices of a company takes into account the distribution of rights and responsibilities among different participants in the organisation such as the board, management, shareholders and other financial stakeholders, and the rules and procedures laid down and followed for making decisions on corporate affairs. ICRA's framework also looks at the composition and the quality of the board of directors, and their level of engagement with the company's operations. The emphasis of ICRA's analysis is on the corporate business practices and the quality of disclosure standards that address the requirements of the regulators and are also fair and transparent for its financial stakeholders.

Accounting Quality

Adherence to the standard accounting practices and transparency in disclosures are critical attributes, and the extent of the same are assessed while taking a view on the accounting quality of the brokerage firm. Specifically, ICRA examines factors such as auditor qualification, quality of disclosures and the transparency of accounting policies for evaluating the adequacy of a brokerage's accounting quality standards. ICRA also factors in the quality of the internal audit process.

Regulatory Compliance

The rules and regulations applicable to stock brokerages, besides being statutory, play an important role in curbing aggressive risk taking behaviour and in enforcing discipline. The ICRA rating methodology not only examines the compliance record of the brokerage being rated, but also its record of litigation. The factors considered include history of non-compliance and severity of regulatory sanctions, history of penal action (deactivation of terminal, etc.) by regulators/exchanges for violation of norms (touching trading limits, etc.) and promptness in restoration of services and history of litigation by retail and/or institutional clients. Factors like the brokerage firm's policy and systems regarding client-related statutory requirements maintenance of client details and margin collections, and systems to monitor the same are also considered.

Business Profile

The inherent strength of the core business proposition of the brokerage house remains critical in order to ensure sustainability as well as scalability of operations. ICRA's analysis of the business profile of brokerage firms factors in the assessment of its operations in relation to the competitive dynamics, quality and robustness of its infrastructure and an evaluation of the risk management practices.

Operational Assessment

ICRA's framework involves an assessment of the strength and sustainability of the brokerage entity's core operations. The framework also captures the entity's ability to scale up its operations, and attract and retain key employees amidst competitive pressures. ICRA's approach of analysing a brokerage firm's competitive dynamics involves looking separately into its each line of business such as retail equity broking, institutional equity broking, commodity broking, debt broking, capital market related funding activities, advisory services, distribution of financial products, arbitrage and proprietary trading and underwriting. The operational assessment is carried out based on the following parameters

- a) **Diversification of Business Revenues:** ICRA looks at the extent of meaningful diversification in the business revenues, that is, types of services, e.g. retail equity broking, institutional equity broking, depository services, portfolio/asset management, margin funding and distribution of financial products. The proportion of revenues and profits from various segments, the extent of correlation between various segments and the stability of earnings from the segment are also considered. Within the retail segment, ICRA also looks at the diversification of revenues in-terms of broking channel, such as traditional broking, online broking and mobile platforms. Since the securities business is cyclical, a high correlation among various businesses of a securities firm would tend to introduce high cyclicity in its income. Given the volatility in the brokerage business, a higher proportion of relatively stable cash flows, which could be through financial products distribution or portfolio / wealth management services, would help sustain operations during cyclical downturns.
- b) **Competitive Position across Segments:** Notwithstanding the fragmented nature of the security broking industry, the brokerage house's scale of operations and its standing in each of the significant segments vis-à-vis competition remains an important parameter while assessing the strength of the underlying businesses. Brokerage houses having a strong market share and an established brand in the key segments are expected to be more likely to withstand downturn in the industry.
- c) **Client Quality and Diversification:** The key factors considered include the type of customers (that is proprietary, retail, high net worth individuals, and institutional), diversification in the clientele and stability of income from various client sets. ICRA notes that high dependence on few clients, particularly institutional clients, increases business risks owing to high client concentration in the revenue stream. Similarly, a high proportion of day trading clients increase volatility in earnings.

In ICRA's view, a company with a small presence in retail broking and no strong brand name is expected to face a stiff competition which could put pressure on its brokerage margins, while on the other hand, a company having presence in investment banking and institutional broking is expected to face little competition as these segments are less fragmented. However, with more and more new players starting their institutional broking and investment banking, this area is also expected to get competitive going forward. Brokerage firms with large scale of operations draw the advantage of established operations and a strong market position and thus are expected to exhibit better resilience during a downturn in capital markets than their small-scale counterparts. The entity's cost-structure, and the mix of fixed and variable costs, would be critical for it to maintain profitable operations during a downturn. Furthermore, the relatively stronger net-worth position of these entities provides them the ability to absorb losses during exigencies.

Business Infrastructure

Being a dynamic industry where timely dissemination of information is very critical, the quality of service provided by a brokerage would depend on its infrastructure. Brokerage firms with poor back-office infrastructure are likely to compromise both on risk management as well as client servicing. Thus, the ICRA rating methodology provides for a close examination of the following aspects:

- a) **Robustness of the information technology (IT) systems:** ICRA analyses the adequacy of infrastructure to ensure uninterrupted operations with efficient real time monitoring and to comply with the requirements of regulators/Stock Exchanges. ICRA also looks at the company's policy and the systems available for business continuity planning such as availability of back-up systems, time taken to restore the connection failure, database maintained, policy on disaster house etc. While broker's existing IT systems may be adequate for current scale of business, ICRA also evaluates the broker's focus on continuous improvement and ability to scale up its IT systems in line with the business growth. Brokerage firms with proven track record of scaling up its business operations without any major disruption due to technical snags would be considered favourably in ICRA's overall assessment.
- b) **Adequacy of management information (MIS) system:** In ICRA's view, robust MIS plays a crucial role in a brokerage firm for monitoring branch efficiency; utilisation of capital placed with the exchange houses, monitoring dealer and client limits besides ensuring smooth running of the normal business operations. Accordingly, ICRA's framework evaluates the quality and timeliness of the reports generated through the MIS system and its relevance for the brokerage firm in improving its business performance.
- c) **Strength of Back Office Operations:** Back office operations serve as a back bone of a brokerage firm for ensuring efficient servicing of the client while mitigating the risk by assigning dealer-wise, terminal-wise, sub-broker-wise and client-wise exposure limits. Brokerage firms with poor back-office infrastructure are likely to compromise both on risk management as well as client servicing. The systems deployed have to be strong enough to be able to capture and report all the transactions of clients without any error. Brokerage firm's back office operation also helps in capturing the client's transaction history on the basis of which a client can be categorized into various segments and accordingly a more customized service can be provided to the client. ICRA's evaluation of brokerage firm's back office operations comprises assessment of the processes, quality of the data captured, storage facility, and the extent of automation.

Risk Management

Brokerage Firms are inherently considered to be risky with extreme volatility possible in the capital market. From the rating perspective, it is of prime importance for a brokerage firm to maintain a separate risk management team independent of the business sourcing and to follow a standardized, system driven, policy-based risk management procedures. ICRA evaluates the adequacy of brokerage firm's risk management systems on the following parameters:

- a) **Risk Governance:** ICRA's framework evaluates the participation of directors (including external and non-executive) in reviewing risk appetites, policies and control effectiveness, clearly laid out individual responsibility for monitoring and reporting risk, documented policies and standard procedures, integration of risk provisions in budgeting, capital allocation for various lines of business and independence of the risk management team. In addition to the above factors, companies doing regular stress testing and upgrading their systems accordingly are also viewed favourably.
- b) **Management of Market Risk:** The analysis of a brokerage firm's exposure to market risk encompasses assessing the mix of proprietary trading versus customer-oriented trading; variability of the trading returns, quantification and reporting of the market risk, risk appetite and hedging strategies; and concentration of risk in debt and equity trading portfolio. Besides analyzing the market risk associated with the proprietary trading, ICRA also evaluates the market risk on the broking client in terms of setting up and monitoring the client-wise exposure limits, quality of the collateral placed by client as margin, allowable time to take the delivery of the stocks in cash segment and margin cover maintained on margin funding clients. A brokerage firm with a small proprietary book as a proportion of the overall asset size, risk-based trading policy, policy-based conservative exposure limits and margin cover and auto-square off mechanism in the event of margin shortfall is viewed favourably by ICRA.
- c) **Management of Credit Risk:** ICRA credit risk analysis evaluates the credit appraisal procedures for approving new clients and new franchisee along with systems and processes for managing risk during operations (for instance country-party limits, margin call policy, efficiency of the follow ups in case of

margin shortfall, collections and recovery process,). ICRA also evaluates the procedures for approving under-writing deals or merchant banking investments and concentration of business with any particular client.

- d) **Management of Operational Risk:** As a routine business operation, brokerage firms are engaged in processing large number of transactions and transferring huge amount of cash and securities every day. For executing such large data based transactions, it is necessary to have efficient and smooth running internal control system. ICRA's analysis on brokerage firm's exposure to the operational risk would be based on the adequacy of the internal control and information systems, training level of the manpower, history of operational failure, ability to restore the operation system, availability of the back-up system, and adequate systems to implement market and credit risk policies.

Financial Strength

ICRA's framework of assessing a brokerage firm's business and financial strength evaluates its ability to scale up its business operations in booming market while ascertaining the sustainability of its business operations in stressful times. ICRA analyses a brokerage firm's business and financial strength on the following parameters:

Earning Strength and Stability

ICRA's framework examines a company's ability to maintain its profitability through economic swings and to generate adequate return on net-worth. A company's earning strength is ascertained through its pre-tax earnings. In ICRA's view, this metric captures a company's scale of operations, franchisee strength and competitive positions and also provides cushion to absorb losses in broking business, which is exposed to the vagaries of capital market. For reducing the effect of cyclical fluctuations as well as any one time loss or gain, ICRA's standard approach for computing pre-tax earnings is to use weighted average of pre-tax earnings from last three years.

To analyse a company's ability to generate revenues while keeping the expenses under check, ICRA analyses pre-tax margins². A company that has large owned retail network, expensive manpower, high lease rentals, inefficient processes is expected to have lower pre-tax margins as compared with other players that have franchisee operated retail network or entities focused on the institutional equity broking. Similarly, the profitability level is lower in a company during an expansion phase as compared to a company with a well established and diversified earning profile and which is optimally utilising the resources and man-power. Brokerage firms with large proportion of variable cost would be more comfortable in protecting its pre-tax margins in stressful times. While calculating total income, brokerage income and trading income is taken on net basis so as to nullify the impact of bloated income for a company largely operating through a franchisee model or engaged in excessive trading. This ratio is also analysed by using weighted average of pre-tax margins for last three years.

In addition to a company's earnings and profitability, ICRA considers the stability of a company's profitability, which refers to its ability to maintain its profit margins within a narrow range across business cycles, to be an important parameter. Moreover, the high dependence of a brokerage firm's profitability on capital markets, which in-turn are characterised as highly dynamic, further underscores the importance of stability of profitability as a parameter for assessing the financial strength of an entity. To analyse this, ICRA examines pre-tax margin volatility calculated by coefficient of variation³ of pre-tax margins for four years.

Asset Quality

It is of prime importance for a brokerage firm to maintain stringent risk management framework and monitoring systems in order to limit any losses associated with a capital market related business operations. In order to capture a long track record of maintaining good asset quality, ICRA's framework evaluates the quantum of provisions on bad debts, write offs of bad debts and error trades on broking

² Defined as Profit before tax / Total income (brokerage income and trading income taken on net basis)

³ Defined as standard deviation / mean of population.

business as a percentage of the company's net-worth and also as a percentage of the operating income⁴ for past several years. In the absence of any stringent regulatory credit provisioning policy, it is difficult to assess a company's asset quality on the basis of the financial indicators alone. For the same, ICRA also analyses the track record of a company in maintaining sufficient margin cover of accepted collateral, typically in the form of listed securities, on their top clients.

Capitalisation and Liquidity Profile

Given the volatile nature of the equity broking industry, a broking house needs to have an adequate level of capital to be placed with the exchange houses for margin requirement. Since sudden liquidity requirement is a possibility (for instance, through higher margin requirement by the Exchange Houses during volatile market and also during the expiry week for every month), the ability to raise funds quickly is a distinct positive for a brokerage firm.

For analysing a brokerage firm's adequacy of funds, ICRA evaluates parameters such as financial flexibility in the form of availability of various sources of funding, quality of capital, committed bank lines for alternative liquidity, average utilisation of the capital placed with the exchange houses, collection period from the clients and capital needs of off-balance sheet transactions. Companies which have a well defined policy of maintaining adequate liquidity in terms of un-utilised bank lines and partly utilised margins placed with the exchange house are viewed favourably. While broking companies are not expected to face any liquidity pressures for debt re-financing obligations as they do not have high borrowing levels, they need to maintain adequate margin cover at the exchange houses to ensure smooth functioning of its terminals during volatile periods. Any company which has its terminal shut down or put up in a square up mode due to margin shortfall is viewed un-favourably.

The rating framework also evaluates a brokerage firm's capital adequacy for its current business operations and its ability to raise further funds for business expansion. In ICRA's view, strong capital levels provide necessary cushion in terms of absorbing any delay in collections from clients and losses during bad capital market. However, a brokerage firm may have deployed a part of its capital towards long-term and ill-liquid investments, which reduce the financial flexibility available with it. Thus ICRA evaluates a company on the basis of free net-worth, which refers to the net worth excluding the long-term, risky and /or ill-liquid investments. Brokerage firms are expected to have low external borrowings, at-least on the balance sheet, as they normally place Bank Guarantees with Exchange Houses for margin requirement. Therefore for the analysis of a company's actual gearing, ICRA also considers the bank guarantees as a part of external debt programme.

Summing up

ICRA's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the instrument being rated. This opinion is arrived at following a detailed evaluation of the issuer's business and financial risks, its competitive strengths, along with an assessment of its management quality and the operating environment. As the note points out, the diversification of business revenues and the competitive position across segments points towards the strength of the operations. Similarly, the robustness of business infrastructure and risks management processes help determine the sustainability of the operations. Given the inherent volatility in the industry, the assessment of the financial risk profile of a brokerage firm also focuses on ascertaining the sustainability of its business operations in stressful times. While several parameters are used to assess the risk profile of a brokerage firm, the relative importance of each of these qualitative and quantitative parameters can vary across companies, depending on its potential to change the overall risk profile of the company concerned.

⁴ Operating income includes net broking income, net interest income, net trading income and other fees income but excluding profit on sale of investments & assets or any other extra-ordinary gains.



ICRA Limited

CORPORATE OFFICE

Building No. 8, 2nd Floor, Tower A; DLF Cyber City, Phase II; Gurgaon 122 002

Tel: +91 124 4545300; Fax: +91 124 4050424

Email: info@icraindia.com, Website: www.icra.in

REGISTERED OFFICE

1105, Kailash Building, 11th Floor; 26 Kasturba Gandhi Marg; New Delhi 110001

Tel: +91 11 23357940-50; Fax: +91 11 23357014

Branches: **Mumbai**: Tel.: + (91 22) 24331046/53/62/74/86/87, Fax: + (91 22) 2433 1390 **Chennai**: Tel + (91 44) 2434 0043/9659/8080, 2433 0724/ 3293/3294, Fax + (91 44) 2434 3663 **Kolkata**: Tel + (91 33) 2287 8839 /2287 6617/ 2283 1411/ 2280 0008, Fax + (91 33) 2287 0728 **Bangalore**: Tel + (91 80) 2559 7401/4049 Fax + (91 80) 559 4065 **Ahmedabad**: Tel + (91 79) 2658 4924/5049/2008, Fax + (91 79) 2658 4924 **Hyderabad**: Tel +(91 40) 2373 5061/7251, Fax + (91 40) 2373 5152 **Pune**: Tel + (91 20) 2556 1194/0195/0196, Fax + (91 20) 2556 1231

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