RATING METHODOLOGY – BROKING

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This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in July 2020. While this revised version incorporates a few modifications, ICRA's overall approach to rating entities in the broking sector remains materially similar.

Overview

Stockbroking houses (henceforth referred to as brokers or broking firms) perform an important role in the capital market by facilitating security trading for all categories of investors. The role of intermediaries such as brokers is critical for developing a capital market structure that provides the market with access to a wide array of investors while also providing it with adequate liquidity.

As the Indian equity broking industry is highly fragmented, investors have a large number of intermediaries at their disposal for transactions on exchange houses. The stockbroking industry is also very dynamic and volatile as it is dependent on the capital market. For instance, broking firms witnessed a challenging phase in FY2009, which exposed them to various business risks associated with equity broking. In a contrasting trend, domestic broking firms registered a healthy performance in FY2021 and FY2022, after a lull in FY2019 and FY2020, supported by favourable liquidity and the healthy participation of retail investors in equity markets.

A key industry trend in the past decade has been the emergence of discount broking houses, which has caused a sharp contraction in broking yields and consequently impacted the profitability dynamics of the industry. In a bid to shore up their profitability and to augment their portfolios, broking firms have been looking at the distribution of financial products and wealth management/investment banking over the past few years.

ICRA’s rating methodology for entities in the broking industry focuses on key operational, financial and qualitative factors that ICRA believes to be most critical in assessing a company’s overall performance, competitive positioning and its ability to withstand a challenging operating environment and service its debt obligations. ICRA also assesses the broking firm’s management based on its track record, quality and risk appetite. For the rating of a broking 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. This rating methodology document is not intended to provide an exhaustive list of all the 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:

Operating Environment

Business Risk Assessment

- Operational Assessment
- Business Infrastructure
- Risk Management

Financial Risk Assessment

- Earnings Strength and Stability
- Capitalisation and Liquidity

Management Risk

Ownership/ Parentage

Assessment of Environmental, Social and Governance Risks

- Environmental and Social Risks
- Governance Practices

Operating Environment

A broking firm's performance is closely linked to the domestic capital markets, which, in turn, are exposed to various macro and micro factors. The broking industry is highly dynamic and less predictable, given the volatility inherent in the capital markets. Thus, for evaluating the credit profile of a broker, an assessment of the operating environment remains critical. A conducive capital market environment, which is characterised by increasing industry broking turnover, rising indices levels, and a growing number of initial public offers (IPOs) and investment banking deals, is expected to help a broking firm improve its financial performance while keeping the associated risks low. On the other hand, an unfavourable capital market with declining broking turnover and volatile stock prices would impact the company's performance. Entities with sizeable proprietary investment/trading operations are also exposed to market risks. This notwithstanding, ICRA's ratings of broking firms may not necessarily change with the change in the state of the capital markets, as the ratings duly incorporate the inherent volatility-induced industry risks.

The regulatory environment also plays a key role as any material change in regulations can have a bearing on the credit profile of the broking houses. Additionally, the competitive intensity in the industry can have a deep impact on a broking 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 broking industry is highly fragmented. Furthermore, the emergence of discount broking houses has disrupted the industry dynamics with a steep correction in broking yields in the past decade.

Business Risk Assessment

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

Operational Assessment

ICRA's methodology involves the assessment of the strength and sustainability of the broking firm's core operations. ICRA's approach towards analysing a broking firm's competitive dynamics involves looking separately at the different lines 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 business revenues, i.e. 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. Client profile and diversification may also be assessed in terms of types of customers (i.e. retail, high-net-worth individuals, institutional), diversification in the clientele and stability of income from various client segments. ICRA notes that high dependence on a few clients, particularly institutional clients, increases business risks owing to significant client concentration in the revenue stream. Similarly, a higher proportion of day trading clients increases the volatility in earnings.

   Within the retail segment, ICRA may look at the diversification of revenues in terms of the broking channel, such as traditional broking, online broking and mobile platforms. Since the securities business is cyclical, a high correlation among the various businesses of a broking firm would tend to result in significant cyclicality in its income. Furthermore, a high share of proprietary investment/trading operations can further increase the broker's risk profile, given the exposure to market risks. Given the volatility in the broking business, a higher proportion of relatively stable cash flows, which could be through financial product distribution or portfolio/wealth management services, would help mitigate earnings volatility during cyclical downturns.

Diversification Assessment

Strongly Positioned	Weakly Positioned
Well-diversified revenues with a presence in different businesses like retail equity broking, institutional equity broking, depository services, wealth/asset management, margin funding/loan against securities and distribution of financial products. The broking/top segment (excluding trading) accounts for less than 50% of the turnover with a material presence in other segments	Broking/top segment accounts for over 75% of the turnover

b) **Competitive Position across Segments:** Notwithstanding the fragmented nature of the broking industry, the broking house's scale of operations and its standing in each significant segment vis-à-vis competition remain important parameters while assessing the strength of the underlying businesses. Broking houses with a strong market share and an established brand in the key segments are expected to be more likely to withstand a downturn in the industry.

Competitive Position Assessment

	Strongly Positioned	Weakly Positioned
Institutional Broking Business	Well-established position in institutional segment with track record and empanelment with leading FIs Or Part of strong & reputable global financial services group And Market share of over 1%	Marginal market share (<0.1%)
Retail Broking Business	Bank brokerage house Or Well-established retail presence, strong brand franchise with over 2% market share	Marginal market share (<0.25%)
Other Fee-based Services	Strong position in other fee-based businesses like investment banking, advisory, wealth management, etc And Fee-based business' assets under advice and/or assets under management of over Rs. 50,000 crore	Marginal presence in other non-broking businesses

In ICRA's view, a company with a small presence in retail broking and limited brand strength is expected to face stiff competition, besides having lower wherewithal to bear the rising compliance costs, which could put pressure on its broking margins. While investment banking and institutional broking face a lower competition as these segments are less fragmented, this area may get more competitive, going forward, with new players foraying into these segments. Broking firms with a large scale of operations have the advantage of established operations and a strong market position and are thus expected to exhibit greater resilience during a downturn in the capital markets compared to their smaller-scale counterparts. Also, the broking firm's cost structure and the mix of fixed and variable costs have a bearing on its ability to maintain profitable operations during a downturn.

Business Infrastructure

The quality of service provided by a broking firm depends on its infrastructure as it is in a dynamic industry where the timely dissemination of information is critical. The quality of a broking house's infrastructure, systems and processes is important for ensuring uninterrupted operations while keeping the operational risks under control. Also, a broking house's information technology (IT) infrastructure not only aids in efficient operations but is also critical for efficient real-time monitoring and to comply with the requirements of regulators/stock exchanges.

The company's management information systems (MIS) also play a crucial role for monitoring branch efficiency, utilising the capital placed with the exchange houses, monitoring dealer and client limits besides ensuring the smooth running of normal business operations. Moreover, back office operations serve as the backbone of a broking 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. Thus, ICRA looks at the infrastructure established by the company, besides its policies and systems for business continuity planning. It is noted that while a broker's existing IT system may be adequate for the current scale of business, focus on continuous improvement and its ability to scale up its IT system in line with the business growth remains imperative.

Business Infrastructure Assessment

Strongly Positioned	Weakly Positioned
No prior concerns on systems or history of interrupted operations Best-in-class systems & infrastructure Continous upkeep/investment in infrastructure	Inadequate systems Limited investment in systems Limited use of technology

Risk Management

It is of prime importance for a broking firm to maintain a separate risk management team, independent of business sourcing, and to follow a standardised system-driven, policy-based risk management procedure. ICRA's framework involves the assessment of the risk monitoring framework of the company, besides its documented policies and standard procedures. The key aspects of risk management in the broking business include:

a) **Management of Market Risk:** The analysis of a broking firm's exposure to market risk encompasses assessing the mix of proprietary trading versus customer-oriented trading, variability of trading income/profits, risk appetite and hedging strategies, and the concentration of risk in the debt and equity trading portfolio. A broking firm with a small proprietary book (as a proportion of the overall asset size and/or net worth) and firm policies (for instance, risk-based trading framework, policies for exposure limits, and auto square-off mechanism in the event of a margin shortfall) is generally viewed favourably by ICRA.

b) **Management of Credit Risk:** Besides analysing the market risk associated with proprietary trading, ICRA evaluates the risks related to the broking client in terms of setting up and monitoring the client-wise exposure limits in case of leveraged exposure taken by clients, the leverage provided by the broking firm through the margin trading facility (MTF), the margin policy (margin calculation, monitoring and call/set-off) and the margin cover maintained on margin funding clients. ICRA also looks at the portfolio's characteristics such as concentration risk, margin cover, etc, in the MTF book.

c) **Management of Operational Risk:** ICRA's analysis of a broking firm's exposure to operational risk is based on the history of operational failures and track record of losses, if any, on account of such failures. Operational risks tend to emanate from sub-par internal control and information systems, among others. Instances of inability to liquidate client positions because of infrastructure breakdown and resultant claims from clients are viewed negatively.

It is of prime importance for a broking firm to maintain stringent risk management frameworks and monitoring systems to limit any losses associated with the capital market-related business operations. To capture the risk management track record, ICRA evaluates the quantum of write-off of bad debts, provisions on bad debts, and error trades on the broking business as a percentage of the company's net worth and its operating income[1] for the past several years. The ICRA rating methodology also factors in the compliance and litigation record of the broking house being rated. The factors considered include history of non-compliance and severity of regulatory sanctions and history of penal action (deactivation of terminal, etc) by regulators/exchanges for violation of norms.

Financial Risk Assessment

ICRA's framework for assessing a broking firm's business and financial strength evaluates its ability to scale up its business operations in a booming market while ascertaining the sustainability of its business operations in stressful times. Furthermore, while ICRA believes that a strong business profile drives a strong financial profile in the long term, the financial profile of an entity is also governed by the risk appetite and growth plans of the management. Accordingly, while assessing the financial risk profile, apart from the past and current financial position, ICRA takes note of the firm's growth plans and the likely impact on its financial position in future. Since the prime objective of the rating exercise is to assess the adequacy of the entity's debt-servicing capability, ICRA draws up projections on its likely financial position. Suitable adjustments are also made in the reported financials to make them suitable for meaningful peer comparison. Overall, ICRA analyses a broking firm's financial strength on the following parameters:

Earnings Strength and Stability

ICRA's methodology involves examining the company's ability to maintain its profitability through economic swings and to generate adequate returns on the net worth. A company's earnings strength is ascertained through the absolute scale of its pre-tax earnings. In ICRA's view, this metric captures the company's scale of operations, franchisee strength and competitive position and provides a cushion to absorb losses in the broking business, which is exposed to the vagaries of the capital market. To reduce the effect of cyclical fluctuations as well as any one-time loss or gain, ICRA's approach for computing pre-tax earnings is to use the weighted average of the pre-tax earnings of the past few years.

ICRA also takes into account the company's pre-tax margin as a measure of profitability[2]. A company that has a large, owned retail network/high lease rental, a captive employee base for business origination and servicing, and inefficient processes is expected to have lower pre-tax margins compared with other players who have a franchisee-operated retail network or entities focused on institutional equity broking. Similarly, the profitability level is lower in a company during the expansion phase compared to one with a well-established and diversified earnings profile as it benefits from better economies of scale. Broking

[1] Operating income includes net broking income, net interest income, net trading income and other fee income but excludes profit on sale of investments & assets or any other extraordinary gains
[2] Profit before tax / Total income (net brokerage income and trading income)

firms with a large proportion of variable costs would be more comfortable protecting their pre-tax margins during stressful times. While calculating the total income, broking income is taken on a net basis to nullify the impact of the bloated income of a company largely operating through a franchisee model. This ratio is also analysed by using the weighted average of pre-tax margins for the past few years to avoid a point-in-time bias. ICRA's methodology also factors in the company's return on equity (RoE) for assessing its earnings and profitability. This ratio is also analysed by using the weighted average RoE for the past few years.

Assessment of Earnings Strength and Stability

[Indicative Metrics[3]]

	Strongly Positioned	Weakly Positioned
Pre-tax earnings (Rs. crore)	>500	<50
Average pre-tax margin	>40%	<10%
Volatility in profit	<5%	>30%
Return on average net worth	>25%	<10%

In addition to the company's earnings and profitability, ICRA considers the stability of its profitability, which refers to its ability to maintain profits across business cycles, to be an important parameter. Moreover, the dependence of a broking firm's profitability on capital markets, which, in turn, are characterised as highly dynamic, further underscores the importance of the stability of profitability as a parameter for assessing the financial strength.

Capitalisation and Liquidity Profile

Given the volatile nature of the broking industry, a broking house needs to have an adequate level of capital to be placed with the exchange houses for margin requirement. Also, strong capital levels provide the necessary cushion in terms of absorbing any losses if needed. Since sudden liquidity requirement is a possibility (for instance, through higher margin requirement by the exchange houses during a volatile market phase and also during the expiry week every month for futures and options), adequate liquidity to meet these short-term requirements along with the ability to raise funds quickly is a distinct positive for a broking firm.

To analyse a broking firm's adequacy of funds, ICRA evaluates parameters such as the availability of various sources of funding, the capitalisation profile, committed bank lines for alternative liquidity (along with underlying security/collateral requirement and drawing power available with the company), average utilisation of the capital placed with the exchange houses and capital needs for margin funding and other requirements. Companies, which have a well-defined policy of maintaining adequate liquidity in terms of unutilised bank lines and partly utilised margins placed with the exchange house, are viewed favourably. ICRA also analyses the policy followed for supporting the shortfall in the cash component of the clients' margin requirement, as firms with a conservative policy in this regard will have low working capital requirements.

Broking houses would require capital to maintain adequate cover at the exchanges to ensure smooth functioning and for providing a margin trade funding facility. While margin trade funding assets are typically short term in nature, the granularity of the book and the margin policy (margin call, set-off and liquidation) help in ensuring the liquidity of the book. While assessing the credit profile of the company, the capital deployed towards subsidiaries, its non-core operations and other illiquid assets (if any) are also considered as these constrain the cash flows and financial flexibility. ICRA also factors in the company's net worth, excluding the long-term, risky and/or illiquid investments, while analysing the capitalisation profile. Broking firms tend to have material non-fund based limits, as they normally place bank guarantees (BGs) with exchange houses for margin requirement. Analysis of non-fund based limits is also carried out while assessing the company's credit profile.

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[3] *The indicative financial metrics mentioned here and elsewhere in the document are intended to provide a broad overview to the readers regarding what ICRA generally considers as 'relatively strong' or 'relatively weak' metrics. It is, however, possible that an entity has relatively weaker metrics on one or more financial parameters, but the specific risk metric is assessed to be low because of other mitigating factors*

Assessment of Capitalisation and Liquidity

	Strongly Positioned	Weakly Positioned
Free net worth (Rs. crore)	> 1,400	<50
Gearing level (on-balance sheet; times)	<0.50	>2.0
Adjusted gearing level (for sanctioned bank lines; times)	<0.75	>2.5
Bank lines utilisation level (12-month average)	<30%	>60%
Access to diverse source of funding	Diversified funding access from sponsors/promoters, more than 5 banks/FIs, and money markets with good refinancing ability	Weak refinancing ability/borrowing relationships with less than 4 banks
Additional margin placement ability (liquidity ratio)*	75%	<25%

**[Unutilised margin (A) + Funds available(B)]/Margin placed at exchange, where (B) is aggregate of unencumbered cash & liquid investment (own funds not placed at exchange or given as collateral) and surplus from margin funding over next three months under a stress case*

Management Risk

Considering the dynamic nature of the domestic capital market, the quality of management is an important parameter in ICRA's framework for assessing a broking firm's rating. While it is easy for broking firms to scale up their business operations during the boom period in the capital market, in ICRA's view, the quality of management remains imperative for tiding over stressful times. ICRA's assessment factors in the stability of the top management, the management's experience in capital market business operations and their track record of successfully responding to changes in the industry dynamics. A broking house with a proven track record of managing its business efficiently through various business cycles, with a professional, experienced and stable management profile and good market reputation is viewed favourably by ICRA.

Other Elements of Credit Risk Assessment

Ownership/Parentage

The risk profile of a broking firm, which is a part of a large corporate group or has an established promoter, can benefit from the experience of the promoter. Moreover, companies backed by strong corporate groups or which have large institutions as strategic investors are expected to have adequate internal controls and processes and are thus expected to provide higher comfort. ICRA reviews the promoter's track record in terms of business growth, risk appetite, leveraging strategy, liquidity policy and transparency in running its operations. Conservative business growth, with a stable track record, would be viewed favourably by ICRA over aggressive business growth with a history of regulatory violations. Over and above the standalone credit considerations, the likelihood of extraordinary support from the parent to an entity or the support that an entity is likely to extend to other group companies is factored in while assessing its credit profile. This process involves the assessment of the ability and willingness of the parent to extend support to the entity, in addition to the evaluation of the entity's own fundamental credit strength.

Assessment of ESG Risks

The assessment of environmental, social and governance (ESG) risks by ICRA involves a broad range of considerations that pertains to the sustainability of an entity with a focus on aspects that can have a material impact on its credit quality. While the environmental and social (E&S) risks tend to be sector-related as well as entity-specific and could be driven by external factors such as regulations or demographic changes, the governance (G) risks are largely entity-driven. The impact of the E&S risks on an entity's credit profile tends to be asymmetric. If the ESG risks are material but unmitigated, these generally pull down the rating, but the rating is usually not pushed up even when the ESG context is favourable.

Environmental and Social Risks

While undertaking the credit assessment of entities, ICRA seeks to incorporate all relevant credit considerations into its rating decisions while taking a forward-looking view on the risks and mitigants. The relevant credit considerations include (sometimes overtly and sometimes covertly) the E&S factors that could affect the rated entity/transaction. While ICRA's analytical approach does not explicitly disaggregate these risks to assess their impact on the rating, these risks are often assessed broadly. Further, it is not always feasible to fully or precisely disaggregate the sub-components of the E&S risks in credit analysis since these considerations often tend to overlap.

While evaluating the E&S risks, ICRA's objective is to assess the direct and indirect risks faced by an entity and how it already is or intends to mitigate the impact of such risks on its credit profile. Given the service-oriented business of entities under consideration, their direct exposure to environmental risks is not material. However, the financial services sector faces risks from a social standpoint. The risk of data breaches and cyberattacks, affecting the large volume of customer data managed by such entities, also exists. ICRA evaluates the disclosures made by such companies outlining their key policies, processes, and investments for mitigating the occurrence of such instances. Any material lapse on this front can result in substantive liabilities, fines or penalties and reputational impact.

Governance Risks

A sound corporate governance structure attempts to provide clarity regarding the distinction between the power and responsibilities of the board of directors and the management. The constitution of an entity's board and the board's participation in strategy formulation, besides its adherence to legal and statutory compliance requirements, are factored in during the credit assessment. ICRA seeks to gain a qualitative understanding of the entity's commitment to following transparent and credible practices from the way its financial statements are reported, its level of disclosures, consistency in communication and the openness about sharing information during the credit rating exercise. Besides the corporate group structure (whether simple or complex), the rated entity's related-party transactions and instances of supporting group entities at the expense of debtholders are assessed. Specifically, ICRA examines factors such as auditor qualification, quality of disclosures, notes to accounts for evaluating the adequacy of accounting quality standards, and the internal audit process.

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 point towards the strength of the operations. Similarly, the robustness of the business infrastructure and risk 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 broking firm also focuses on ascertaining the sustainability of its business operations in stressful times.

ANNEXURE

Summary of rating factors and an example to illustrate the key building blocks of a credit rating for a broking company

Category	Sub-category	Strong	Comfortable	Adequate	Moderate	Weak
Business Risk	Operational Assessment					
	Business Infrastructure					
	Risk Management					
	Asset Quality					
Financial Risk	Earnings Strength and Stability					
	Capitalisation Profile					
Management & Governance	Management Quality and Governance					
		Superior	**Strong**	**Adequate**	**Stretched**	**Poor**
Liquidity Indicator	Liquidity					
		Enhance		**Neutral**		**Hinder**
Does this Factor Enhance or Hinder the Credit Profile?	Parent/Group Support					

Final Rating	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B/ C category

The above graphic is only for illustration purpose and does not represent a rating output from a formulaic model. The ratings assigned by ICRA are determined by Rating Committees based on both quantitative and qualitative considerations.

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About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

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