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SECURITIES BROKING INDUSTRY

Clouds continue to gather over securities broking industry

AUGUST 2024

Highlights

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Proposed measures aim to curb speculative trading, potentially dampening trading volumes; market stability and investor protection remain regulator's priority

Reversion in derivatives trading volumes to historical levels cannot be ruled out; may necessitate adjustments to business models of brokers, including potential fee recalibration, to maintain profitability

The Indian equity derivatives market has undergone significant evolution during the last four years, marked by a substantial rise in retail participation and speculative trading. While the number of demat accounts and active investors has surged, particularly noteworthy is the tenfold growth in derivatives traders, with India now accounting for over 30% of global exchange-traded derivatives trades.

The growth has been accompanied by concerning levels of trading losses incurred by individual investors. Moreover, expiry days, occurring throughout the week, have become hotspots for trading, characterised by significant volatility and last-minute hyperactivity and speculative trades.

The aforesaid observations have raised concerns among the regulator about the potential risks to market stability and investor protection, leading to proposals for stricter controls, including limiting weekly options to a single index, increasing margins on expiry days, and enhancing the monitoring of position limits. The proposed measures also include the review of the minimum contract size for index derivatives contracts, rationalisation of strike prices for options, upfront collection of options premium, and removal of calendar spread benefit on expiry day.

These regulatory concerns were echoed in the Union Budget for FY2025 as well, which increased the securities transaction tax (STT) on futures and options (F&O). The Securities and Exchange Board of India (SEBI) has also mandated that Market Infrastructure Institutions (MIIs) implement 'true to label' charges to ensure fairness in fee structures. The combined effect of the recent policy actions and these regulatory measures, if implemented, will significantly increase the friction in trading volumes in the F&O segment, potentially leading to a meaningful decline in the same. For broking firms, these changes present challenges as well as some opportunities. While broking income of the F&O segment is expected to face pressure, new opportunities could arise, particularly in margin financing. However, these developments would likely require a recalibration of the business models, including adjustments to brokerage fees and a possible shift from brokerage-free products.

SEBI proposes measures for index derivatives segment to ensure market stability and investor protection

1. Rationalisation of strike price for options
2. Upfront collection of options premium
3. Removal of calendar spread benefit on expiry day
4. Intraday monitoring of position limits
5. Review of minimum contract size for index derivatives contracts
6. Rationalisation of weekly index products
7. Increase in margin near contract expiry

Source: sebi.gov.in, ICRA Research

Regulator has taken stock of evolving trends in equity derivatives segment

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Changing market dynamics in equity derivatives segment in recent years with increased retail participation and heightened speculative trading volumes

- Demat accounts in India rose to 15.8 crore as on May 31, 2024, of which 12.2-crore accounts were opened since April 2020.
- During this period, the active National Stock Exchange (NSE) client base increased by 3.8 times to over 4 crore. The increase in participation in derivatives was even sharper at 10 times.
- Indian markets are estimated to account for over 30% of the global exchange-traded derivatives trades, aided by technology, increasing digital access and varied product offerings.
- In FY2024, 92.5 lakh unique individuals and proprietorship firms traded in the index derivatives segment of the NSE and cumulatively incurred a trading loss of over Rs. 51,000 crore.

With the launch of weekly derivatives contracts on the benchmark index by the NSE in February 2019, trading activity has shifted towards index options

- The growth in derivatives was driven by index options. Over the years, the index options segment has primarily shown real growth in turnover.
- For every Rs. 100 traded by an individual investor (in derivatives segment) in FY2018, only Rs. 2 went to the index options segment. This number rose to Rs. 41 in FY2024.
- The repositioning of expiry dates by the exchanges has resulted in the expiry of weekly index derivatives contracts on all five trading days of the week. Till 2022, the expiry date of weekly contracts was only on a single day of the week.
- Hyperactive trading activity is being witnessed on expiry days, which account for the majority of the notional turnover for various index derivatives contracts. Further, up to 40% of the notional turnover on the expiry day is witnessed in the last 60 minutes.

Source: sebi.gov.in, ICRA Research

Speculative hyperactivity in derivatives markets seen to be endangering market stability and investor protection

As per the regulator, large open interest and hyperactive trading activity close to expiry have implications for market stability.

During June 2023 to July 2024, NIFTY was seen to be more volatile on the expiry day compared to non-expiry days. The last half an hour of continuous trading has been observed to be the most volatile on expiry days compared to non-expiry days.

The lower premium on the expiry day most likely makes F&O trading on that day a cheap speculative activity for some individuals, irrespective of the odds of success.

Participants are estimated to be initiating and squaring off positions in a time span of less than 3 minutes, thereby speculating significantly, minutes before contract expiry.

The concentrated hyperactivity in derivatives on the expiry date does not benefit the overall securities market ecosystem.

In fact, the absolute value of the net trading loss borne by individuals in FY2024 in index derivatives was over 32% of the net inflow in the growth and equity-oriented schemes of all mutual funds during the year.

Source: sebi.gov.in, ICRA Research

Rationalisation of weekly index products and strike prices to prevent speculative activity near contract expiry and scattered liquidity across strikes

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Existing Practices and Issues

Weekly expiry derivatives contracts are offered by stock exchanges in addition to monthly contracts. Such weekly contracts expire on all five trading days of the week across different indices/exchanges, leading to the movement of speculative money from one expiry of index to another every day.

Multiple options strikes are introduced at uniform price intervals around the prevailing index value by exchanges. For instance, Bank Nifty contracts have 45 In the Money and 45 Out of Money strikes at the time of introduction. A large number of strikes with wide coverage can scatter liquidity across multiple strikes, causing sudden price movements in such contracts.

A sample analysis shows that an open position is, on average, held by a retail investor only for around 30 minutes. Also, in many cases, the expiry day trading in options is as high as 80-90% of the notional turnover of the weekly index options contracts in the expiry week.

Proposals

Large open interest and hyperactive trading activity close to expiry have implications for market stability. As per the regulator, if a black swan event occurs minutes before expiry with large activity at stake, the potential stress to the ecosystem with short options rushing to hedge can be immense. Hence, the regulator has proposed to limit the weekly options contracts to a single benchmark index of an exchange.

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The existing strike price introduction methodology may be rationalised to ensure that not more than 50 strikes are introduced for an index derivatives contract at the time of contract launch. The strike interval should be uniform near the prevailing index price and will increase as the strikes move away from the prevailing price.

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Source: sebi.gov.in, ICRA Research

Multiple measures targeted at increasing upfront capital requirement to address the issue of high implicit leverage in options contracts, especially near expiry

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Existing Practices and Issues

Trading activity, quantum of open positions and volatility increase around expiry; however, this is not factored in the form of an increase in the margin to account for the higher risk. In fact, the premium traded decreases close to expiry, creating higher risk on notional basis for entities dealing in options.

There is a stipulation for the upfront collection of margins for futures as well as options. However, no explicit stipulation for the upfront collection of options premium from options buyers exists.

The margin requirement for a derivatives position reduces by offsetting the position on a future expiry as the calendar spread margin applies to such position instead of the margin on the two positions. However, the value of the contract expiring can move differently from the derivative value on the away month expiry. Also, liquidity risk arises as away month options have lower liquidity.

Proposals

The margins on the expiry day and the day before expiry are to be increased. At the start of the day before expiry, the extreme loss margin (ELM) is to be increased by 3%. At the start of the expiry day, the ELM is to be increased further by 5%.

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The minimum contract size of index derivatives contracts is to be raised. Also, the members are to collect the options premiums on an upfront basis from the clients to avoid any undue intraday leverage to the end client.

2 5

Given the skewed volumes witnessed on the expiry day vis-à-vis other non-expiry days and the inherent risks present therewith, the margin benefit for the calendar spread position would not be provided for positions involving any contract expiring on the same day.

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Source: sebi.gov.in, ICRA Research

Increased monitoring of position limits for index derivatives to necessitate changes in technology

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Existing Practices and Issues

The position limits* for various participants/product types are specified by SEBI. These limits are monitored by clearing corporations/stock exchanges at the end of the day.

Undetected intraday positions beyond the permissible limits could exist, particularly on the day of expiry, as the end of day open positions would be nil.

Proposals

Considering the evolving market structure, the position limits for index derivatives contracts shall also be monitored by the clearing corporations/stock exchanges on an intraday basis, with an appropriate short-term fix and a glide path for full implementation, given the need for corresponding changes in technology.

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*Source: sebi.gov.in, ICRA Research; *For example, for a trading member, mutual fund and foreign portfolio investment (FPI) category I, specified position limit is Rs. 500 crore or 15% of the total open interest of the market in index options, whichever is higher*

Aforesaid proposals follow the policy action seen in the preceding weeks

STT on futures and options hiked by 60%

In the Union Budget for FY2025 presented in July 2024, the STT on futures and options has been increased to 0.02% and 0.1%*, respectively, from 0.0125% and 0.0625%*, respectively. The revised rates will be applicable from October 1, 2024.

The increase in STT is sizeable and will result in a meaningful rise in the overall transaction cost associated with derivatives trading. This, coupled with other policy actions, will induce friction in F&O trading volumes. Nonetheless, the Government has budgeted only a 16% growth in STT collections compared to the 60% increase in the incidence rate for F&O. Thus, the budgeted number is achievable even with 30% lower trading volumes (across segments) hereon (compared to the run rate for Q1 FY2025). If cash segment volumes are assumed to sustain (as STT rates have been revised only for F&O), the budgeted collection will be achievable even in case of a much higher dip in derivatives trading volumes. It is, however, noted that trading volumes in recent months have been above the average trajectory witnessed in FY2024.

MIIs directed to levy 'true to label' charges

SEBI has directed market participants that MII charges (such as exchange transaction charges), which are recovered from the end client, should be true to label, i.e. if a certain MII charge is levied on the end client by brokers, the same amount is to be received by the MII. The charge structure of the MII should be uniform and equal instead of slab-wise, viz. dependent on the volume of brokers.

Given the existing volume-based slab-wise charge structure, the aggregate charges collected by the brokers from the end clients have typically been higher than the charges paid to the exchanges. The resulting income for a broker would be maximum if the highest slab rate is being charged to the clients, while it may be eligible for the lowest slab rate due to the scale of volumes. The difference between the highest and lowest slabs is much more pronounced in the options segment compared to the cash segment; hence, the potential net income earned by brokers is much more significant in options. Thus, discount brokers with a higher share of trading volumes from the options segment and with a business model of earning from the aforesaid spread will be impacted the most.

*Source: sebi.gov.in, ICRA Research; *Applicable on premium turnover*

ICRA-rated entities have seen multifold growth in F&O broking volumes during past four years

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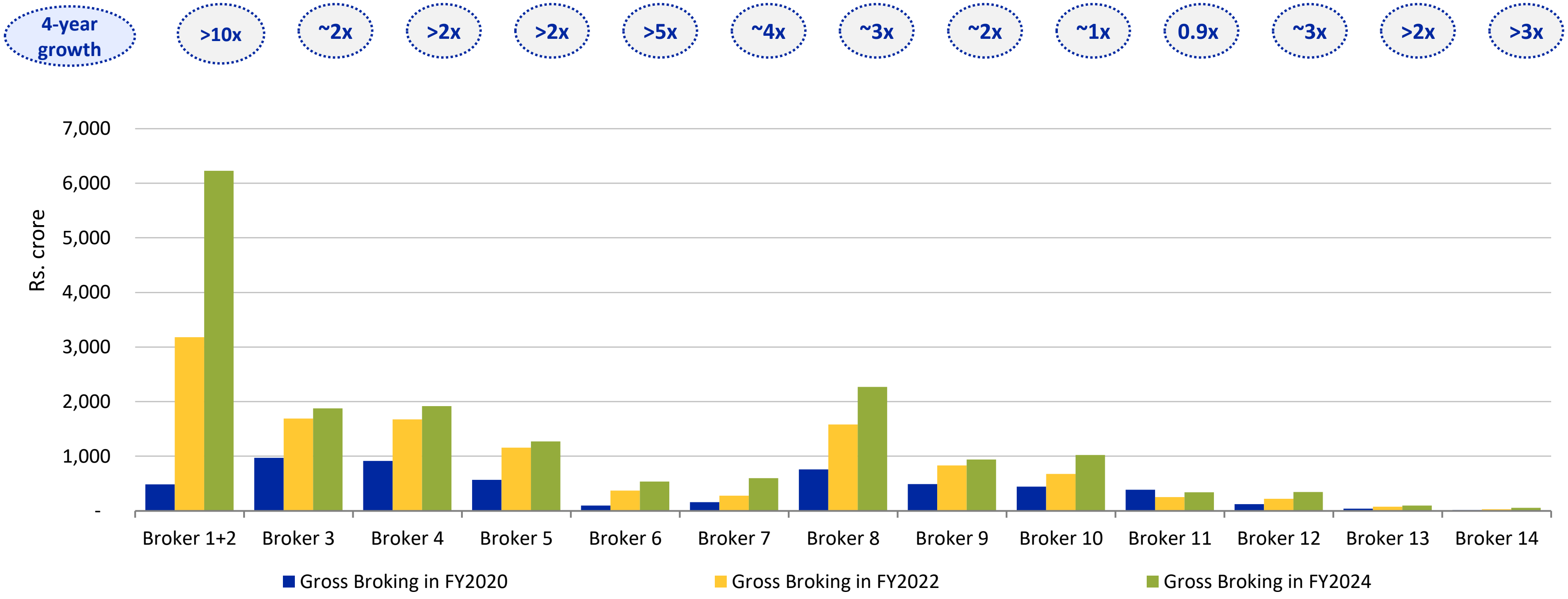
Exhibit 1: Growth in F&O broking volumes (notional turnover)*

	Broker 1+2	Broker 3	Broker 4	Broker 5	Broker 6	Broker 7	Broker 8	Broker 9	Broker 10	Broker 11	Broker 12
F&O Volume Growth in FY2024 Vs. FY2020	>20x	5x	>50x	19x	~5x	13x	25x	7x	25x	~4x	3x
F&O Volume Growth in FY2024 Vs. FY2022	NA	3.5x	>10x	5x	~3x	7x	6x	2x	7x	~1.3x	2x

*Source: ICRA Research; *ICRA's estimates*

Multifold growth in broking income of F&O segment as well, though lower than volumes due to price erosion

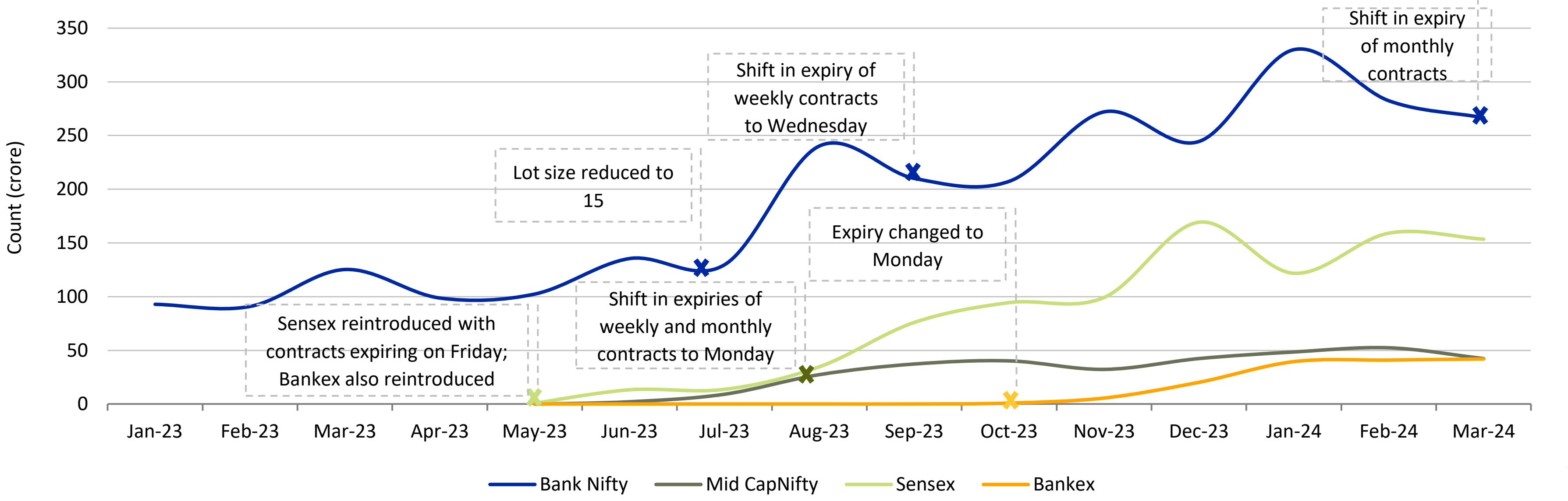
Exhibit 2: Trend in gross broking income from F&O segment



Source: ICRA Research

Significant boost in options volumes in last two years due to an expiry a day

Exhibit 3: Trend in count of options contracts traded



Expiry days have historically witnessed higher trading on account of the relatively low premiums and faster time decays. With separate expiry days for each index derivative (such as Nifty Midcap on Monday, Fin Nifty on Tuesday, weekly Bank Nifty on Wednesday, Nifty 50 on Thursday, and Sensex and Bankex on Friday), a sizeable increase in volumes has been witnessed.

Source: NSE, BSE

Exchange activity surged in recent periods

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Exhibit 4: Announcements made by exchanges in recent past

NSE

Jul -23	Aug -23	Mar-24	Apr-24	Jul-24
Lot size of Bank Nifty reduced to 15 from 25	*Shift in expiries of weekly & monthly contracts of Nifty Midcap to Monday*	*Shift in monthly expiries for Bank Nifty to Wednesday* *Lot size cut for 42 stocks out of 182*	*NSE cuts transaction charges in cash & equity derivatives by 1%* *Nifty 50 lot size reduced to 25 from 50*	*Lot size of Fin Nifty reduced to 25 from 40* *Launches F&O on Nifty Next 50 index*

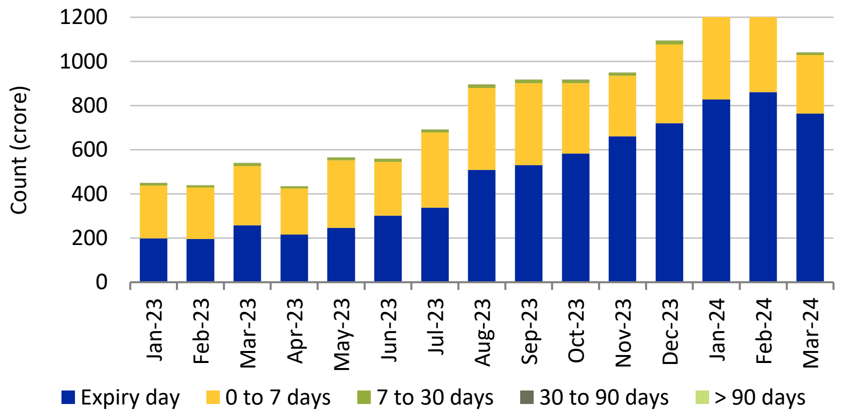
BSE

May -23	Oct -23	Nov-23/Apr-24	Jul-24
F&O contracts relaunched in Bankex & Sensex *Lot size for Sensex revised to 10 (from 15) and Bankex revised to 15 (from 20)*	*Shift in expiry of Bankex contracts from Friday to Monday*	*Cuts down transaction charges in S&P Sensex options before increasing them in April 2024, amid revision in regulatory fee structure*	*Expiries of monthly stock derivatives revised to second Thursday of the month from the fourth Thursday of the month*

Source: ICRA Research

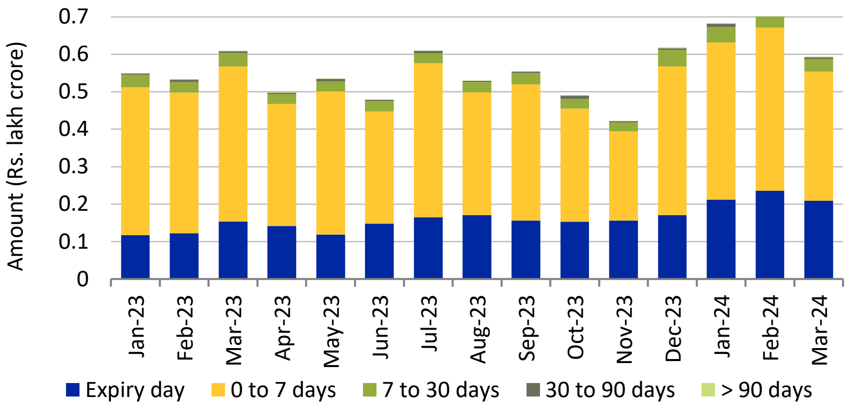
Zero-day expiry trades now account for sizeable share of overall contracts traded

Exhibit 5: Trend in tenure-wise index options contracts traded



Source: SEBI, ICRA Research

Exhibit 6: Trend in tenure-wise premium ADTO of index options traded – NSE



Source: SEBI, ICRA Research

- Weekly options have gained popularity among investors due to their low premiums, thereby contributing about 81% to the options contracts traded.
- With higher leverage, while zero-day expiry trades accounted for only about 30% of the overall premium turnover, they drove about 62% of the overall options contracts traded in FY2024. The higher leverage on zero-day expiry contracts on account of low time value can be witnessed from the fact that, on May 23, 2024, the premium for the nearest at the money call option expiring on the same day was trading at 0.4 times of the premium of the option with 7 days to expiry and 0.1 times of the premium of the option expiring on 30 days.

Relatively new products have started accounting for over a third of overall options contracts traded

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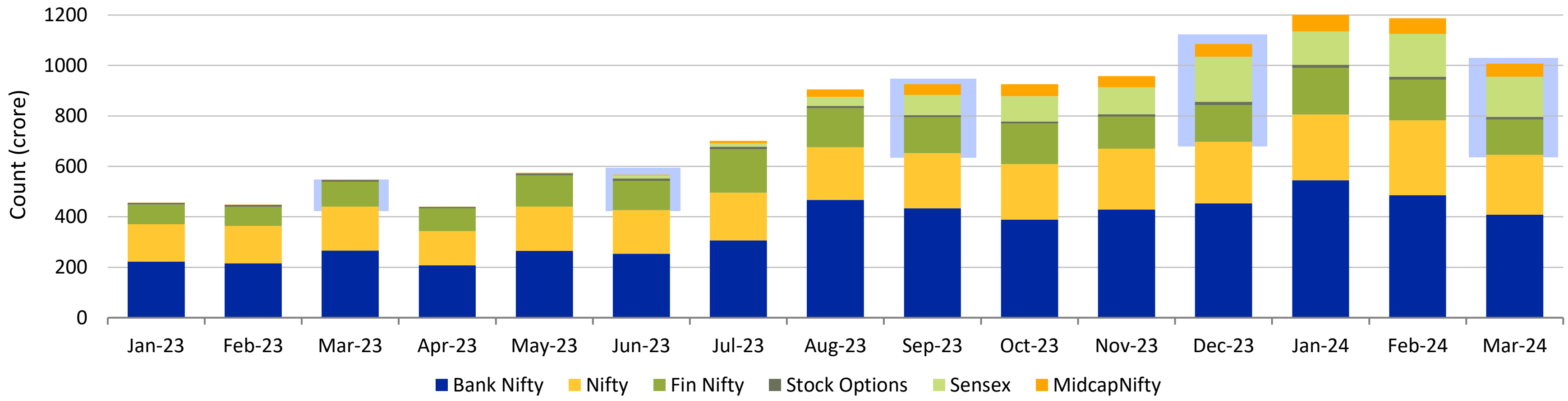
Exhibit 7: Trend in category-wise count of options contracts traded



Source: NSE, BSE, ICRA Research

- With the introduction of new index options such as Nifty Midcap Select from January 2022, Nifty Financial Services Index from January 2021 and the relaunch of Bankex and Sensex derivatives contracts in May 2023, the share of new products in the overall options contracts traded increased to 38% in March 2024 from 29% in September 2023.

Reversion in trading volumes to FY2022 level cannot be ruled out, implying contraction in broking income with maximum impact on discount brokers

Exhibit 8: Potential decline in broking fee if F&O volumes revert to FY2022 level (vis-à-vis FY2024; assuming no second order impact on cash segment)

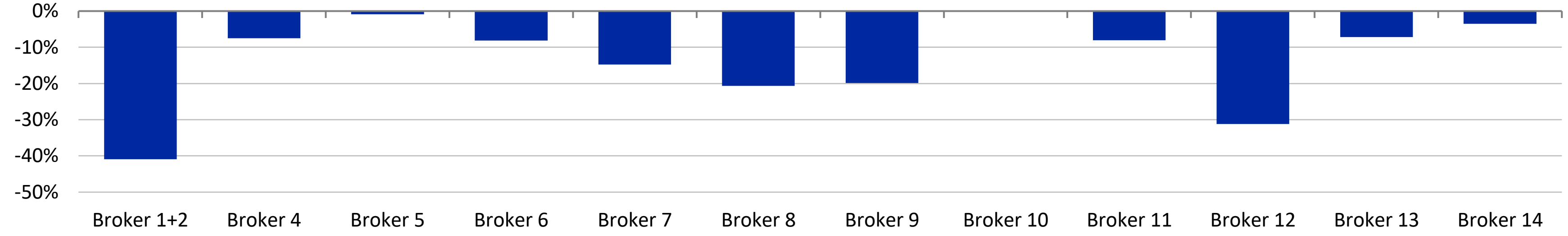
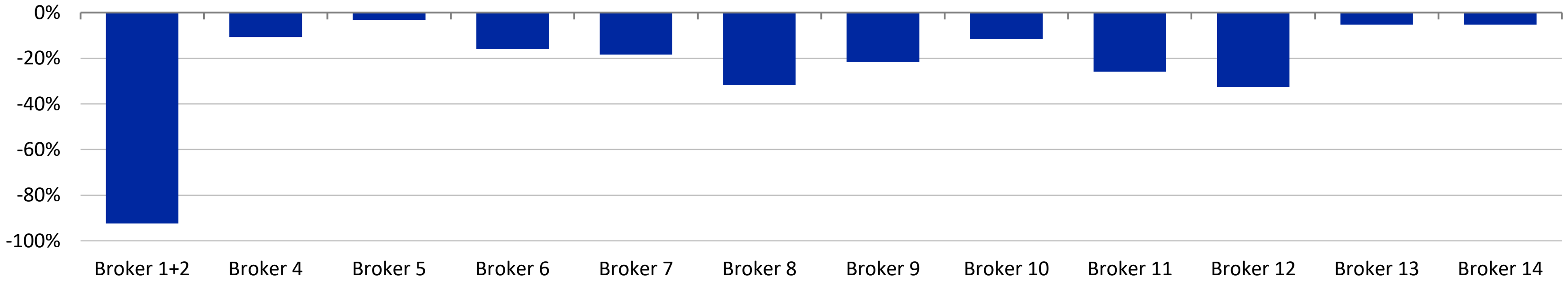


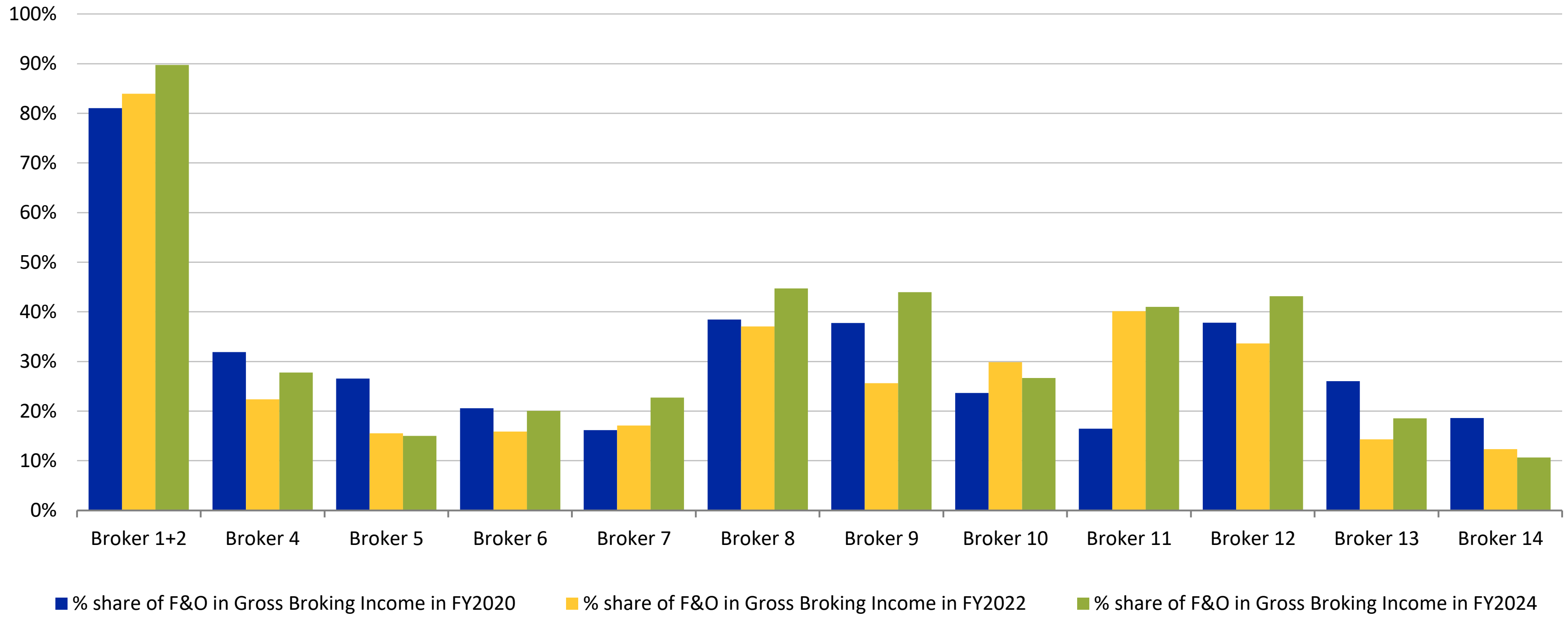
Exhibit 9: Potential decline in broking fee if F&O volumes revert to FY2020 level (vis-à-vis FY2024; assuming no second order impact on cash segment)



Source: ICRA Research; Note: Data not available for Broker 3

While share of F&O segment in broking income has increased, it accounts for less than half of broking revenues for most, barring discount brokers

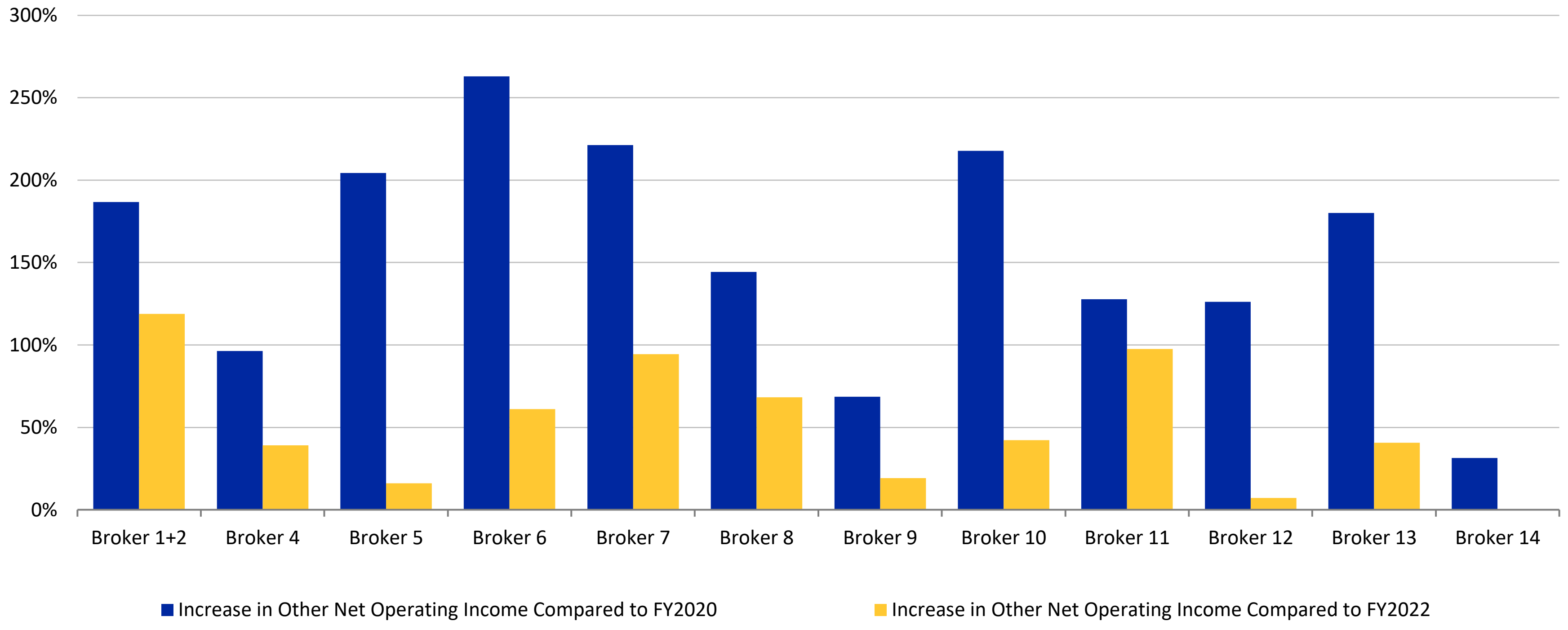
Exhibit 10: Share of F&O segment in broking income – FY2024 vs. FY2022 vs. FY2020



Source: ICRA Research; Note: Data not available for Broker 3

Income from other revenue sources has also increased considerably for many brokers during this period

Exhibit 11: Revenue from other sources (other than broking) such as distribution, capital market lending, investment banking, etc



Source: ICRA Research; Note: Data not available for Broker 3; Note: Discount brokers, while not significantly present in allied activities, have seen growth in non-broking revenues due to interest income on float as well as net worth funded liquid investments

So, decline in net operating income would be relatively lower, assuming no second order impact on other offerings

Exhibit 12: Potential decline in net operating income if F&O volumes revert to FY2022 level (vis-à-vis FY2024, assuming no 2nd order impact on other segments)

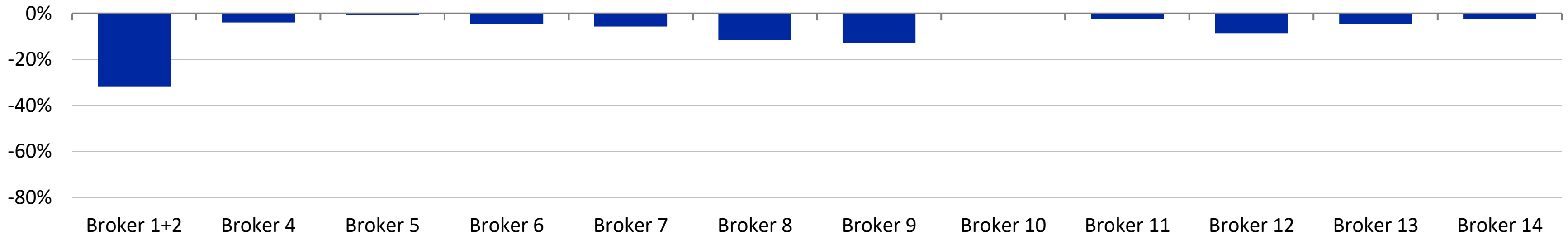
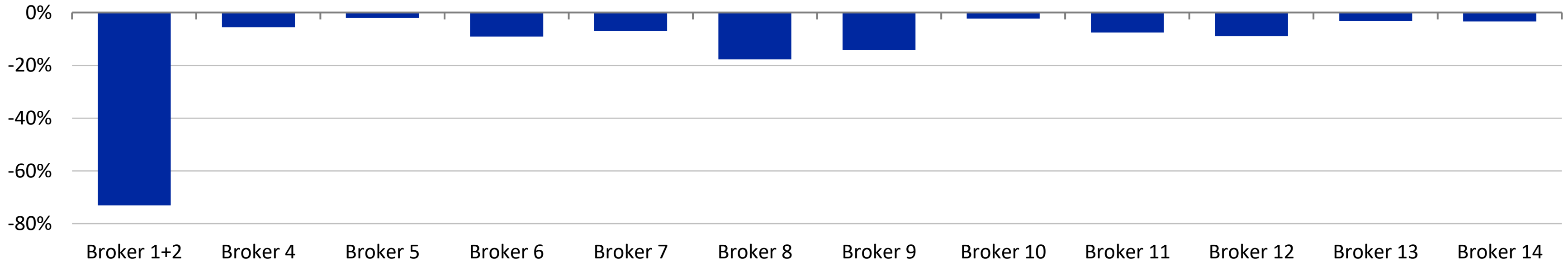
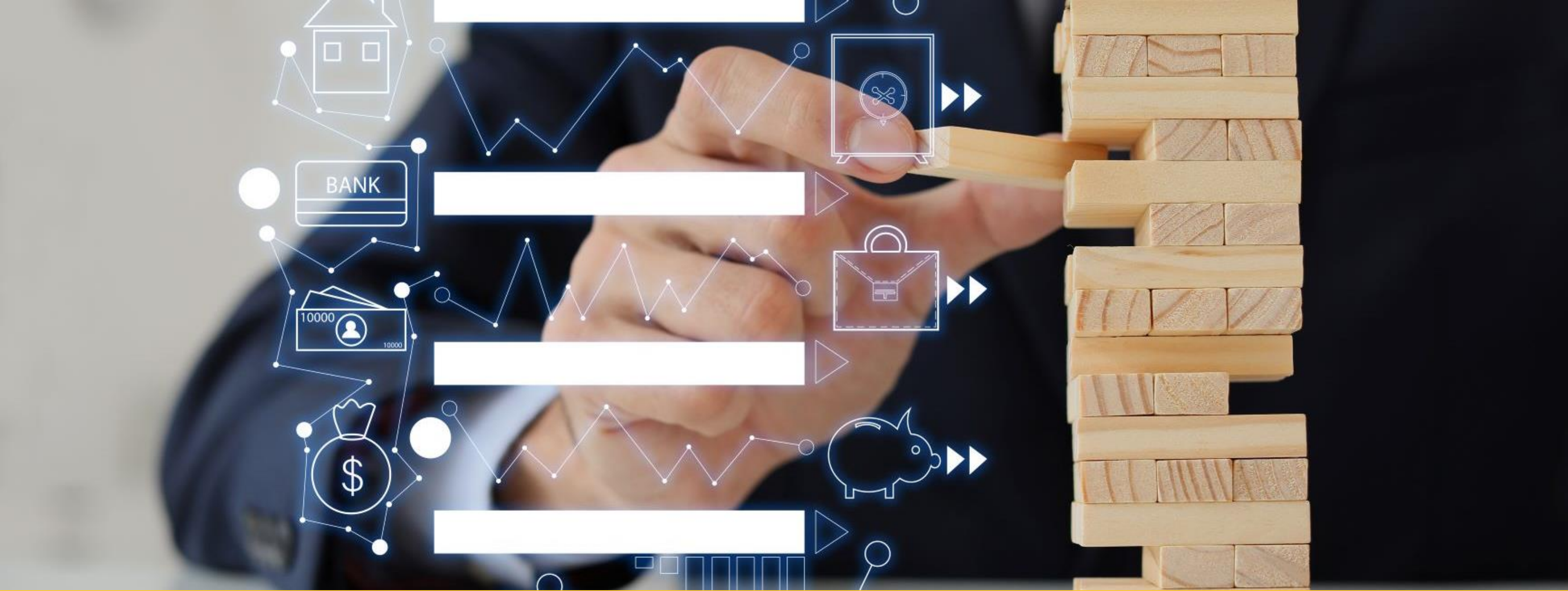


Exhibit 13: Potential decline in net operating income if F&O volumes revert to FY2020 level (vis-à-vis FY2024, assuming no 2nd order impact on other segments)



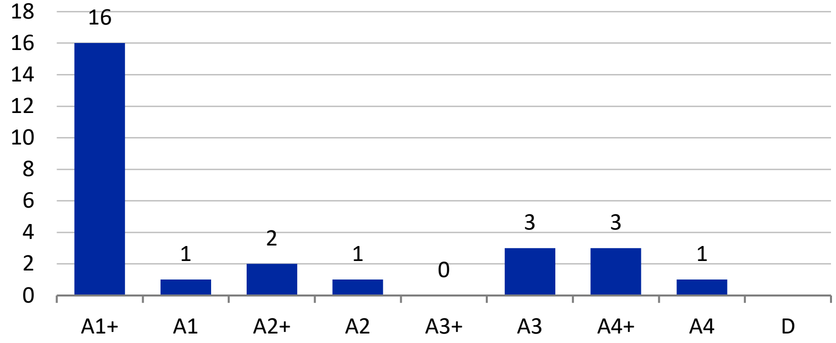
Source: ICRA Research; Note: Data not available for Broker 3



Annexure

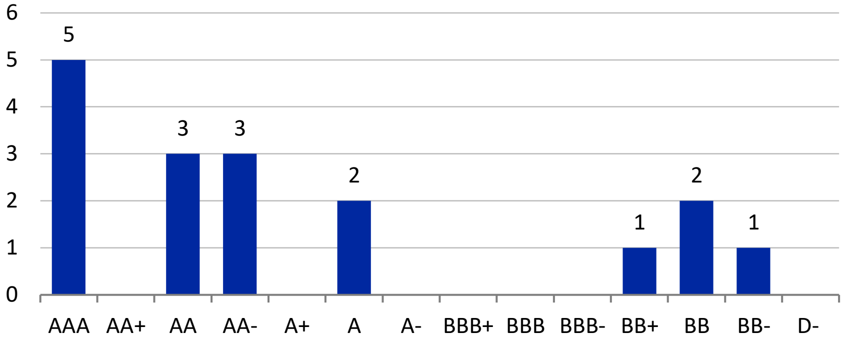
ICRA's coverage of brokerage industry^

Exhibit 14: Distribution of ICRA's short-term ratings for brokerage companies



Source: ICRA Research; ^ As on June 30, 2024

Exhibit 15: Distribution of ICRA's long-term ratings for brokerage companies



Source: ICRA Research; ^ As on June 30, 2024

- ICRA has ratings outstanding on 30 brokerage companies.
- Of these, ICRA has long-term ratings outstanding for 17 companies while 27 have been rated on the short-term scale. The median long-term rating for brokerage companies is in the AA category, reflecting the strong franchise and/or parentage of the ICRA-rated universe of brokerage companies.
- The long-term rating of one securities broker was upgraded in FY2024 due to the steady scale-up of its operations and the consistency of its profitability, while the rating of one company was downgraded on account of its weakened performance.

ICRA-rated securities broking entities – I

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Exhibit 16: List of ICRA-rated securities broking entities^ – I

Company Name	Long-term (LT) Rating	Outlook on LT Rating	Short-term (ST) Rating
Axis Securities Limited	[ICRA]AAA	Stable	[ICRA]A1+
Barclays Securities (India) Private Limited			[ICRA]A1+
Centrum Broking Limited			[ICRA]A3
Cholamandalam Securities Limited			[ICRA]A1+
Emkay Global Financial Services Limited			[ICRA]A2+
GEPL Capital Private Limited	[ICRA]BB-	Stable	[ICRA]A4
Globe Capital Market Limited	[ICRA]AA-	Stable	
Groww Invest Tech Private Limited	[ICRA]AA-	Stable	[ICRA]A1+
HDFC Securities Limited	[ICRA]AAA	Stable	[ICRA]A1+
ICICI Securities Limited	[ICRA]AAA	Stable	[ICRA]A1+
IIFL Securities Limited			[ICRA]A1+
JM Financial Institutional Securities Limited	[ICRA]AA	Stable	[ICRA]A1+
JM Financial Services Limited	[ICRA]AA	Stable	[ICRA]A1+
Kotak Securities Limited	[ICRA]AAA	Stable	[ICRA]A1+
Manubhai Mangaldas Securities Pvt Ltd	[ICRA]BB	Stable	[ICRA]A4+

Source: ICRA Research; ^ As on March 31, 2024

ICRA-rated securities broking entities – II

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Exhibit 17: List of ICRA-rated securities broking entities ^ – II

Company Name	LT Rating	Outlook on LT Rating	ST Rating
Master Capital Services Ltd.			[ICRA]A2+
Motilal Oswal Financial Services Limited	[ICRA]AA	Positive	[ICRA]A1+
Nuvama Wealth Management Limited	[ICRA]AA-	Stable	
Pace Stock Broking Services Pvt. Ltd.	[ICRA]A	Stable	
PhillipCapital (India) Private Limited			[ICRA]A1
Prabhudas Lilladher Private Limited			[ICRA]A2
Pragya Securities Private Limited			[ICRA]A3
Rakhecha Securities Limited	[ICRA]BB	Stable	[ICRA]A4+
SBICAP Securities Limited			[ICRA]A1+
Sharekhan Limited			[ICRA]A1+
SMC Global Securities Limited	[ICRA]A	Stable	[ICRA]A1+
Standard Chartered Securities (India) Limited	[ICRA]AAA	Stable	[ICRA]A1+
Sushil Financial Services Private Limited			[ICRA]A3
Systematix Shares and Stocks (India) Ltd	[ICRA]BB+	Stable	[ICRA]A4+
360 One Distribution Services Limited			[ICRA]A1+

Source: ICRA Research; ^ As on March 31, 2024

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Thank You!