SECURITIES BROKING INDUSTRY

Stockbrokers brace for impact as regulator tightens index derivative framework

OCTOBER 2024

Highlights

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New directives aimed at market stability and investor protection; likely to curb speculative hyper trading activity in index derivatives

Dip of about 30% in derivative trading volumes cannot be ruled out; interest income earned from client funds could also be impacted to some extent

Developments to induce brokers to recalibrate their revenue/pricing models

Given the concerns on market stability and losses incurred by individual investors amid material increase in retail participation in index derivatives, on October 01, 2024, the Securities and Exchange Board of India (SEBI) introduced six measures to strengthen the equity index derivative framework for protecting market stability and enhancing investor protection. The measures include rationalisation of weekly index derivatives, increase in their contract size, upfront collection of option premium from buyers, increase in margins on expiry days, removal of calendar spread benefits on expiry days, and enhancing the monitoring of position limits. This follows the earlier consultation paper floated by the regulator in July 2024 on seven measures for promoting market stability. Additionally, in a bid to enhance the protection of investors' cash collaterals, SEBI mandated qualified stockbrokers (QSB) to offer facility of trading supported by blocked amount in the secondary market (cash segment) using the UPI block mechanism or the 3-in-1 trading facility, which was optional so far.

The proposed measures will be introduced in a phased manner between November 2024 and April 2025. With the combined effect of the aforesaid measures and the recent hike in security transaction tax in the F&O segment, in ICRA's assessment a ~30% dip in F&O volumes cannot be ruled out. The impact of the same would be more prominent for discount brokers since 70-80% of their income comes from F&O brokerage. Many full stack brokers, on the other hand, with a more diversified revenue mix generate 10-20% of their income from F&O and, hence, would face a lower impact. Further, a meaningful adoption of UPI block on secondary trades or a 3-in-1 trading account could also impact the interest income of stockbrokers. Considering these recent headwinds, stockbrokers would require to recalibrate their business models, including upward revision in brokerage fees and a possible shift from brokerage-free products to maintain their profitability. As per ICRA's assessment, ceteris paribus, a 25% hike in F&O pricing could be required to materially offset any impact on F&O broking income.

SEBI strengthens index derivatives framework for increased market stability and investor protection

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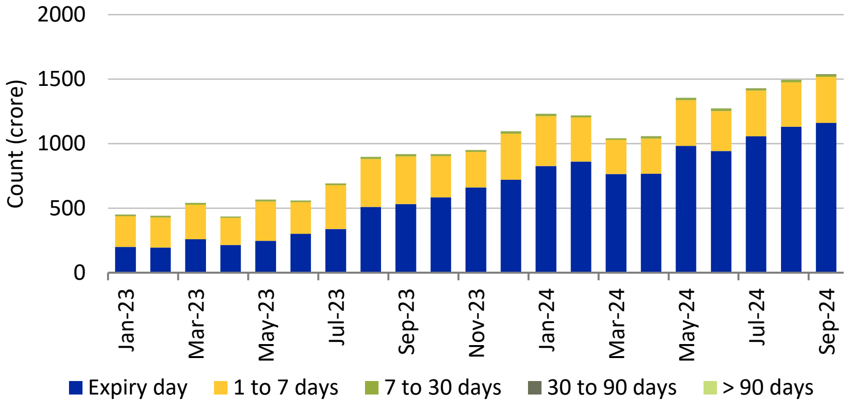
1. **Rationalisation of weekly index derivatives**
   (From Nov 20, 2024)
2. **Increase in contract size for index derivatives**
   (From Nov 20, 2024)
3. **Increase in margin close to contract expiry**
   (From Nov 20, 2024)
4. **Removal of calendar spread benefit on expiry day**
   (From Feb 01, 2025)
5. **Upfront collection of options premium**
   (From Feb 01, 2025)
6. **Intraday monitoring of position limits**
   (From Apr 01, 2025)

Source: sebi.gov.in, ICRA Research

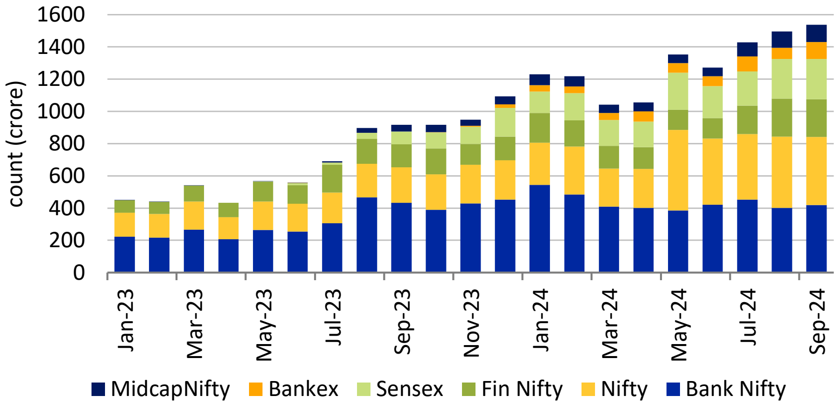
Weekly index options have gained attention due to surge in hyperactive trading

Exhibit 1: Trend in tenure-wise index options contracts traded



Source: SEBI, ICRA Research

Exhibit 2: Trend in index options contracts traded



Source: SEBI, ICRA Research

- Expiry days witness higher trading on account of the relatively lower premiums and faster time decays. With introduction of new weekly index derivatives (Bankex, Sensex, Fin Nifty and Midcap Nifty) in the post-pandemic period coupled with separate expiry days for each product, the industry has been witnessing an expiry a day.
- With shorter expiries and lower premiums, weekly index derivatives have emerged as a popular trading instrument. The popularity of weekly contracts is evidenced from the fact that during H1 FY2025, weekly expiry contracts accounted for over 75% of overall option contracts traded.

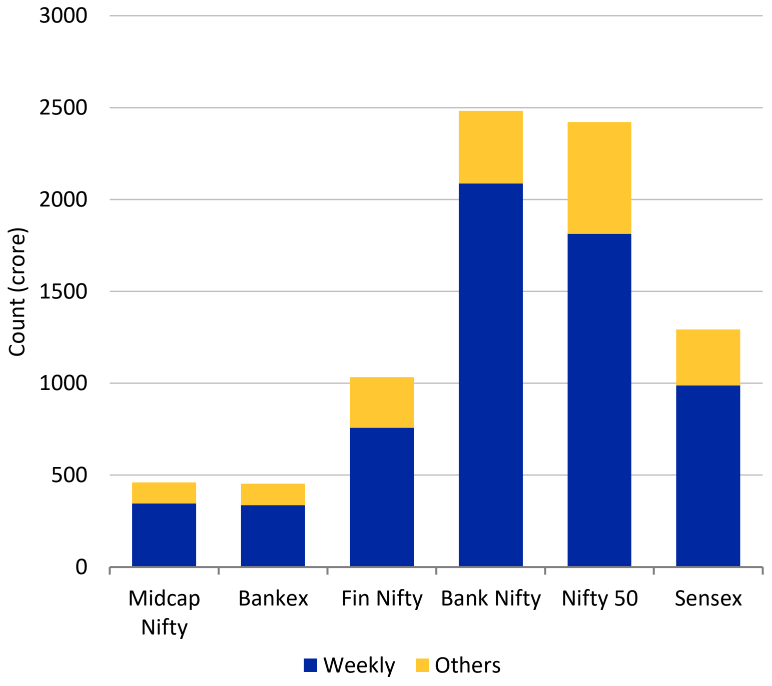
Rationalisation of weekly index derivatives to result in material reversion in F&O volumes

Weekly expiry derivatives contracts are offered by stock exchanges in addition to monthly contracts. With repositioning of expiry dates by the exchanges, such weekly contracts expire on all five trading days of the week across different indices/exchanges compared to one expiry day till 2022, leading to the movement of speculative money from one expiry of index to another every day.

Large open interest and hyperactive trading activity charterised with a very low holding period close to expiry hold implications for market stability and investor protection. To address the same, the regulator directed exchanges to offer weekly expiries on only one of their benchmark indices starting November 20, 2024.

During H1 FY2025, barring the leading weekly index option contracts of exchanges (Bank Nifty for NSE and Sensex for BSE), weekly contracts for the remaining three index options accounted for ~45% of overall index options traded. With rationalisation of weekly index derivatives, the traction across new index derivatives would cease.

Exhibit 3: Break-up of weekly and monthly/ quarterly contracts traded in H1 FY2025



Source: sebi.gov.in, ICRA Research; Note: NSE: National Stock Exchange of India Limited; BSE: BSE Limited (formerly Bombay Stock Exchange)

Increase in contract size likely to disincentivise smaller retail traders

In the past few years, the industry witnessed significant increase in retail participation in the F&O segment; however, 9 out of 10 traders incurred significant losses. The case was more concerning for the low-income segment characterised by annual income below Rs. 5 lakh. In FY2024, low-income traders, who accounted about 75% of overall F&O traders, incurred average losses of Rs. 60,000, a considerable share of their annual income. In light of this, a recalibration of the appropriateness of the participants in F&O was necessitated.

The contract size requirements for derivative contracts were last set between Rs. 5 lakh and Rs. 10 lakh in 2015. Since then, broad market values and prices have increased by around three times. In light of this, the regulator mandated the increase of the minimum contract value to Rs. 15 lakh starting November 20, 2024. Further, the lot size is to be managed in a manner such that the contract value of the derivative remains within Rs. 15–20 lakh.

In this regard, a similar action was seen in South Korea in 2012, wherein the contract value of KOSPI 200 options was increased by 5 times. There was a 76% YoY decline in option contracts traded in the subsequent half year. Nonetheless, the current increase in contract value for Indian index derivatives would be in the range of 2.4 to 3.0 times. Further, the pricing for options in India is on per order basis, especially for brokers having high dependence on F&O segment. As per ICRA's preliminary estimates, currently less than 15% of the order values are below the proposed increase in minimum contract size. Thus, the impact is estimated to be lower compared to what was witnessed in South Korea.

Source: sebi.gov.in, ICRA Research

Multiple measures aimed at increasing margin requirements likely to address high inherent leverage in option contracts

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Existing Practices and Issues

Trading activity, quantum of open positions and volatility increase around expiry. This is not factored in the commensurate 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 exists for the upfront collection of options premium from options buyers. Further, while the position limits for various participants/product types are monitored at the end of the day, undetected intraday positions beyond the permissible limits could exist.

The margin requirement for a derivatives position reduces by offsetting the position on a future expiry as the calendar spread margin applies to such a 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.

Revisions in framework

To cover the tail risk in short option contracts, an additional extreme loss margin (ELM) of 2% will be applicable on the expiry day starting November 20, 2024.

To avoid any undue intraday leverage available to the end-client, it has been decided to collect upfront option premium from option buyers by TMs/CMs. Further, the regulator enhanced the monitoring of position limits for index derivatives contracts on an intraday basis. Starting April 01, 2025, stock exchanges are directed to consider a minimum of four position snapshots during the day.

Given the significant basis risks on the expiry day vis-à-vis other non-expiry days and the inherent risks therein, the margin benefit for the calendar spread position would not be provided for positions involving any contract expiring on the same day, starting February 01, 2025.

Source: sebi.gov.in, ICRA Research; Note: TM: Trading member; CM: Clearing member

Reversion in trading volumes to 2022 levels cannot be ruled out

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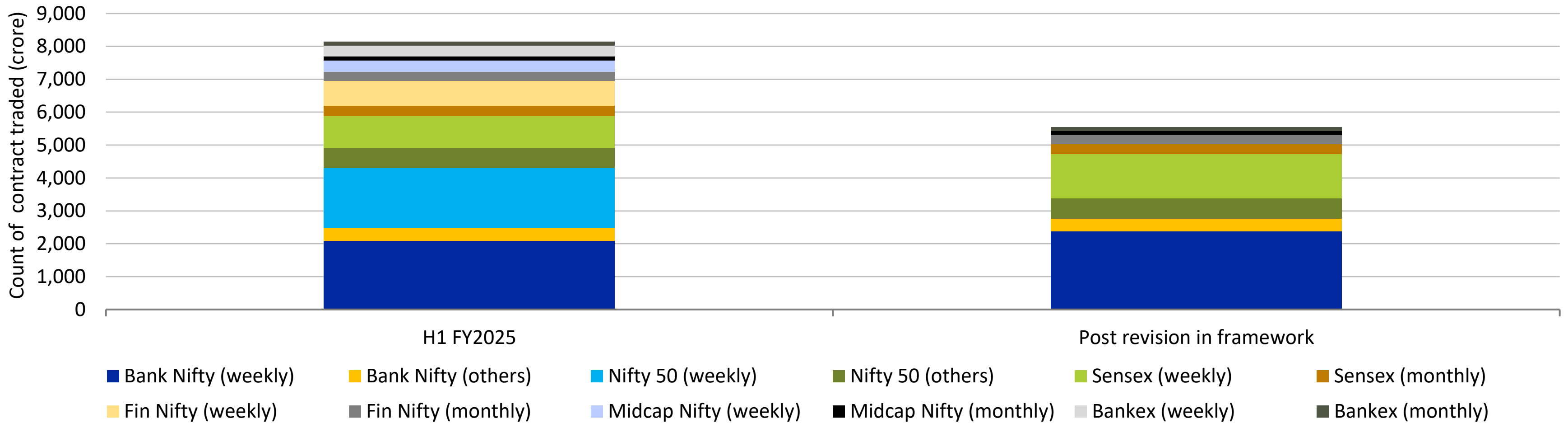
Exhibit 4: Estimated impact on index option contracts



Bank Nifty and Sensex remain the top index derivative contracts for NSE and Sensex, respectively. Assuming weekly expiries on Bank Nifty and Sensex to continue, and an estimated 20% shift in trading volumes from weekly contracts traded of Nifty 50, Bankex, Midcap Nifty and Fin Nifty to top traded index derivatives of exchanges (i.e., Bank Nifty and Sensex), a possibility of about 30% dip in the option contracts traded cannot be ruled out, going forward.

Source: NSE, BSE, ICRA Research

Initiatives for enhanced protection of cash collateral likely to impact interest income earned by stockbrokers

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In a bid to further enhance the protection of client's cash collaterals, In January 2024, SEBI introduced a supplementary mechanism for trading in secondary markets in the cash segment by integrating UPI service of single block and multiple debits. Under the application supported by a blocked amount (ASBA) facility, the client can trade in the cash segment of the secondary market based on blocked funds in his/ her bank account, instead of transferring the funds upfront to the trading member. Clients can also earn interest from the funds in their bank account. Currently, the facility is optional for investors and not mandatory for TMs, to offer as a service to clients.

Given the adequate transaction processing capacity, the regulator mandated qualified stockbrokers (QSB) to offer facility of trading supported by blocked amount in the secondary market (cash segment) using the UPI block mechanism or the 3-in-1 trading facility starting February 01, 2025. The clients, however, will have the option to either continue with the existing trading facility by transferring funds to TMs or opt for either of the facilities to be offered by QSBs.

The impact of introducing the ASBA facility or 3-in-1 trading accounts for trading in secondary markets will be dependent on adoption of such facilities by clients. ICRA notes that the propensity to adopt the ASBA facility would however be impacted by the limitations on the number of UPI blocks available and associated cap on quantum or the inability to avail margin financing/ add-on services. Nonetheless, the average daily cash balance of clients with TMs stand large at about Rs. 65,000 crore-Rs. 70,000 crore, on which the TMs earn interest income. Further, QSBs account for about 65-70% of the gross traded value of the industry.

Source: sebi.gov.in, ICRA Research

Aforesaid proposals follow the policy action seen in the preceding months

STT on futures and options hiked by 60%

In the Union Budget for FY2025 presented in July 2024, the securities transaction tax (STT) on futures and options was increased to 0.02% and 0.1%*, respectively, from 0.0125% and 0.0625%*, respectively. The revised rates became 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. Coupled with other policy actions, this 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 market infrastructure institution (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 volume-based and slab-wise charge structure earlier, the aggregate charges collected by the brokers from the end-clients were typically higher than the charges paid to the exchanges. The resulting income for a broker was maximum if the highest slab rate was charged to the clients, while it was eligible for the lowest slab rate due to the scale of volumes. The difference between the highest and lowest slabs was much more pronounced in the options segment compared to the cash segment; hence, the potential net income earned by brokers was 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*

Multifold growth in broking revenue from F&O segment in preceding years

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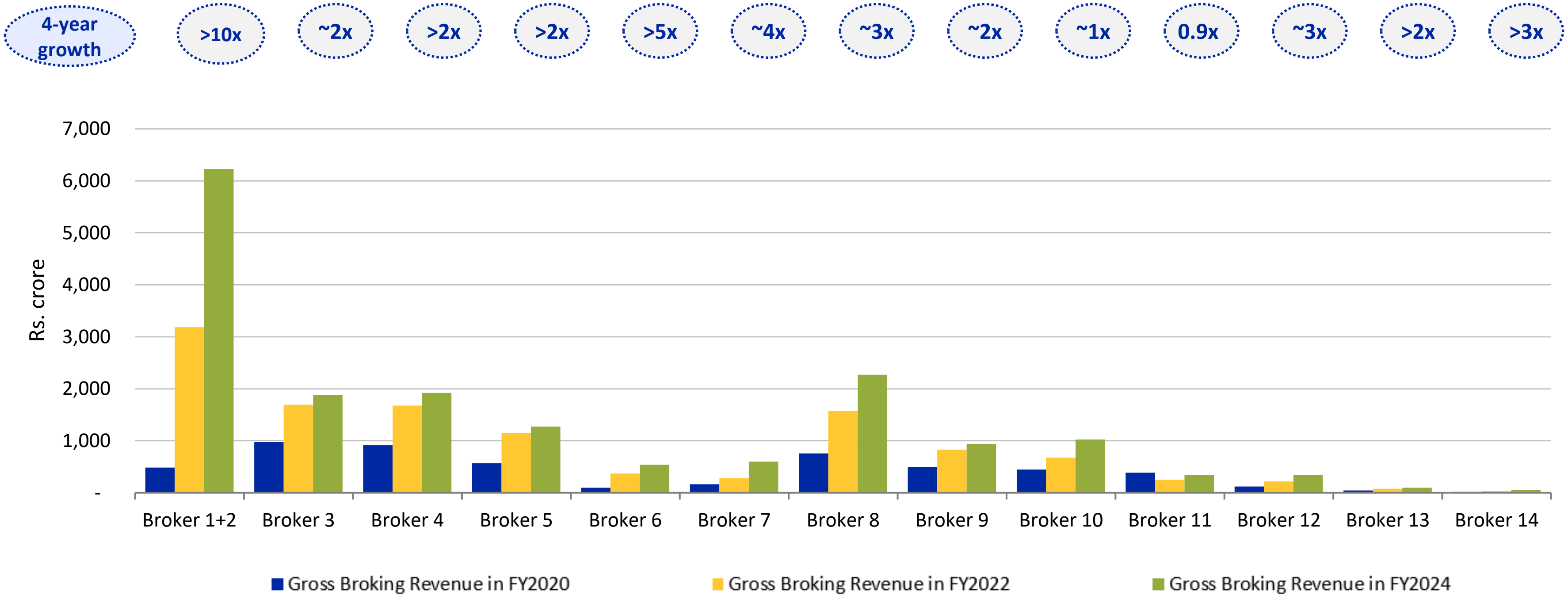
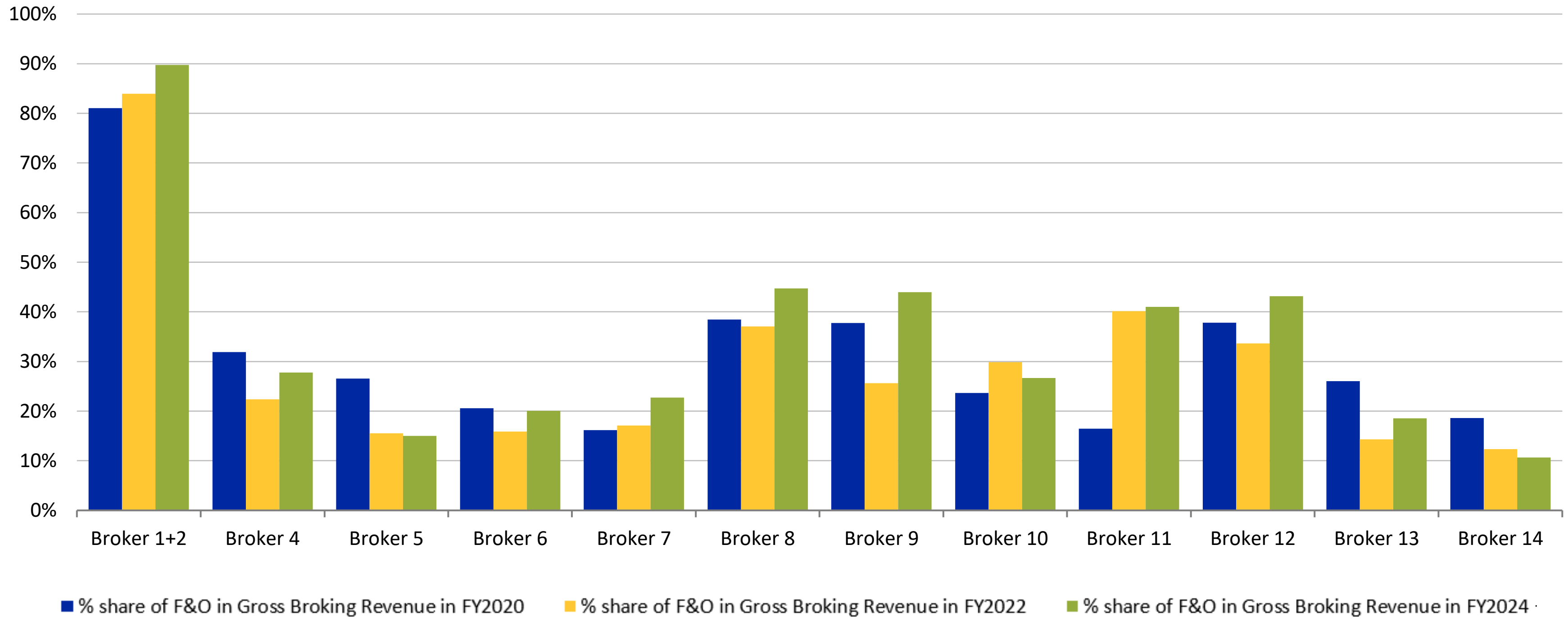
Exhibit 5: Trend in gross broking revenue from F&O segment



Source: ICRA Research

F&O segment related broking revenue, however, accounts for less than half of broking revenues for most, barring discount brokers

Exhibit 6: Share of F&O segment in broking revenue – FY2024 vs. FY2022 vs. FY2020



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

Contraction in broking revenue expected to have maximum impact on discount brokers

Exhibit 7: Potential decline in broking fee if F&O volumes revert to FY2022 level*

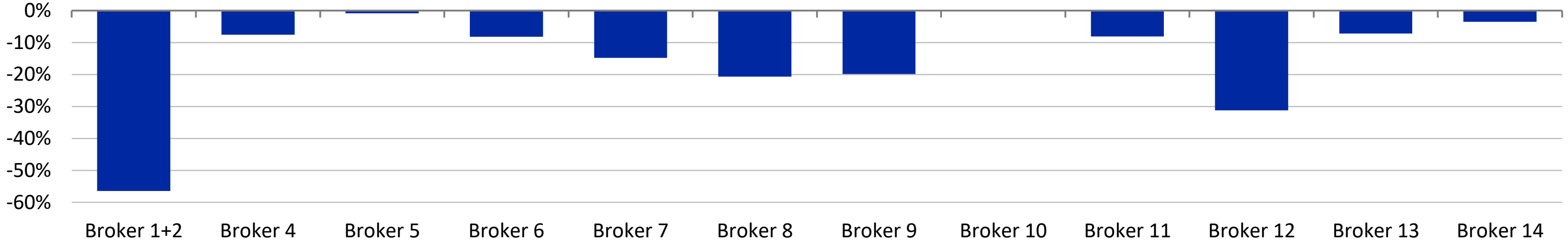
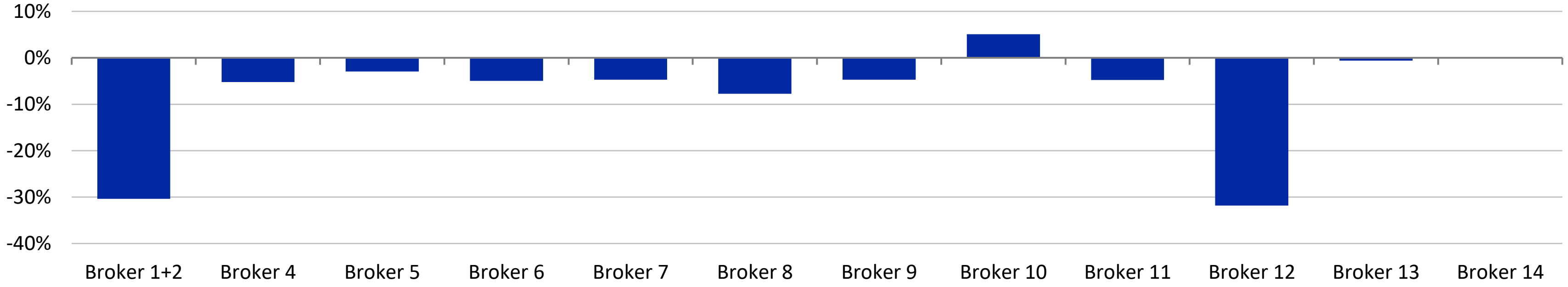


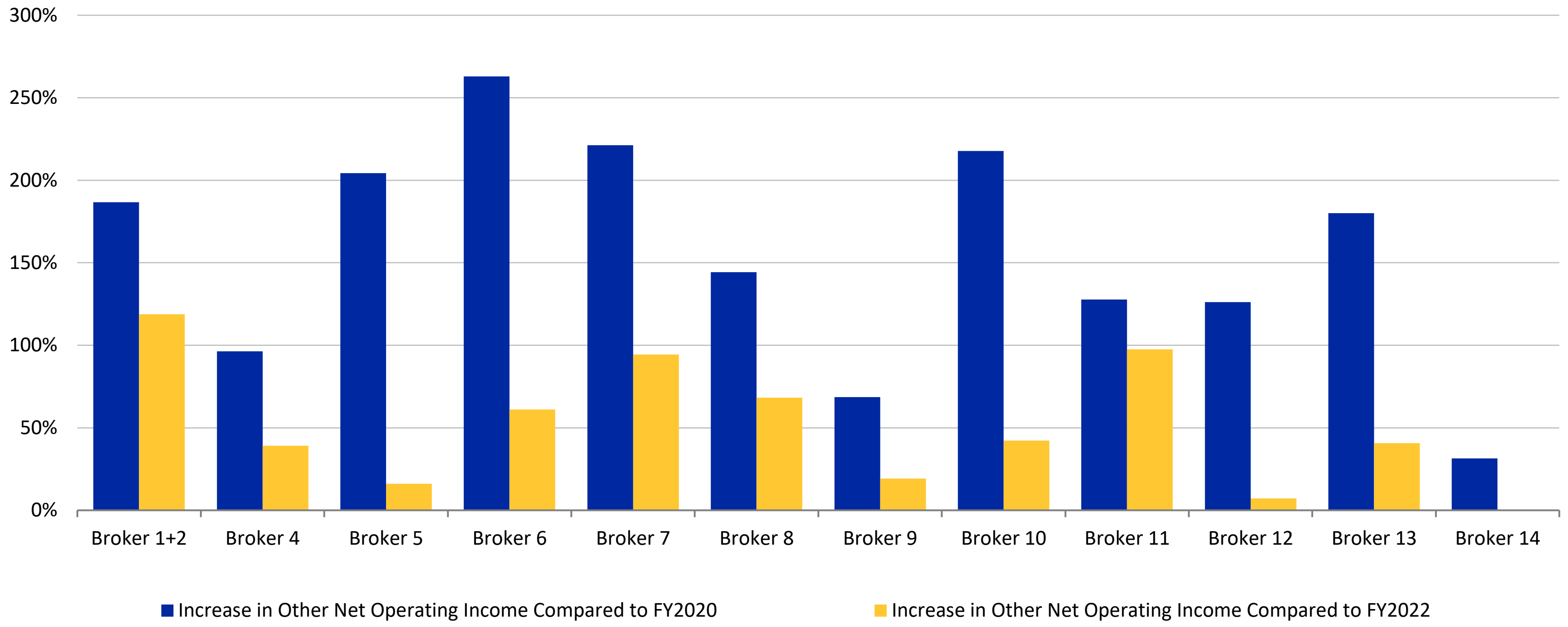
Exhibit 8: Potential decline in broking fee if F&O volumes revert to FY2023 level*



*Source: ICRA Research; Note: Data not available for Broker 3; * vis-à-vis FY2024; assuming no second order impact on cash segment*

Income from other revenue sources also increased considerably for full stack brokers during this period

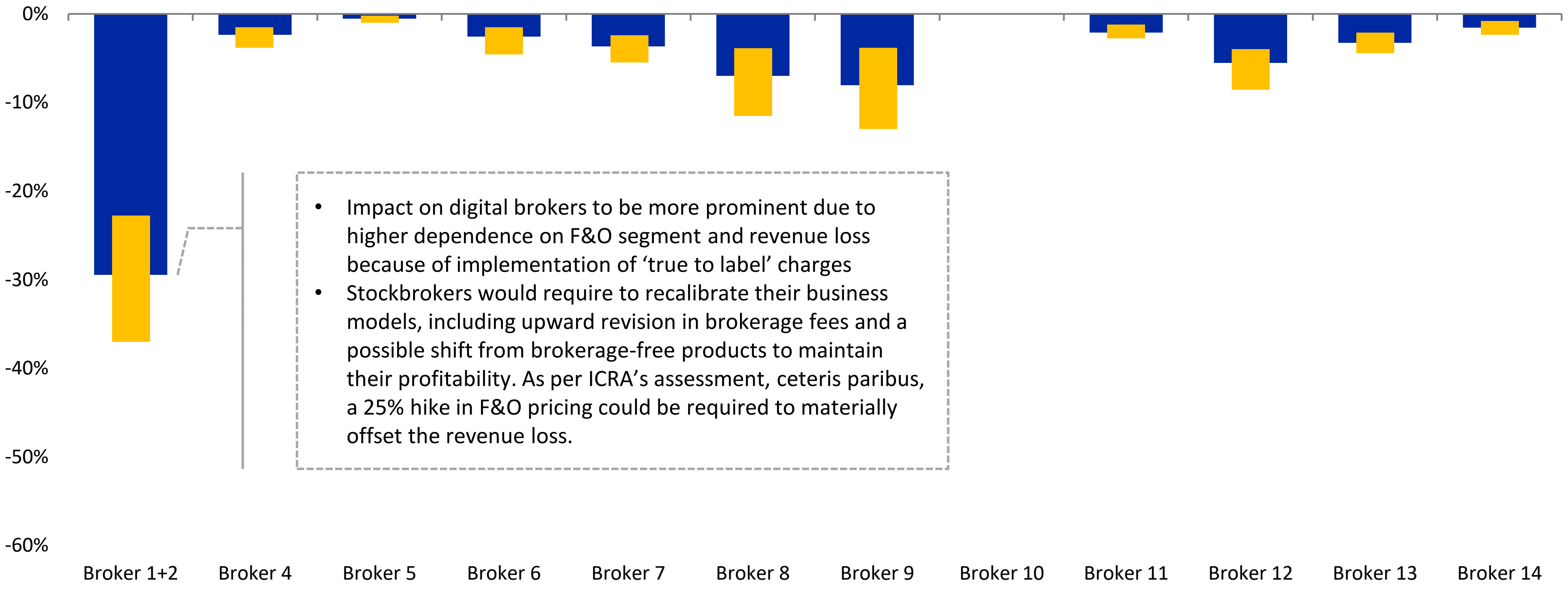
Exhibit 9: Revenue from other sources (other than broking) such as distribution, capital market lending, investment banking, etc



Source: ICRA Research; Note 1: Data not available for Broker 3; Note 2: 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

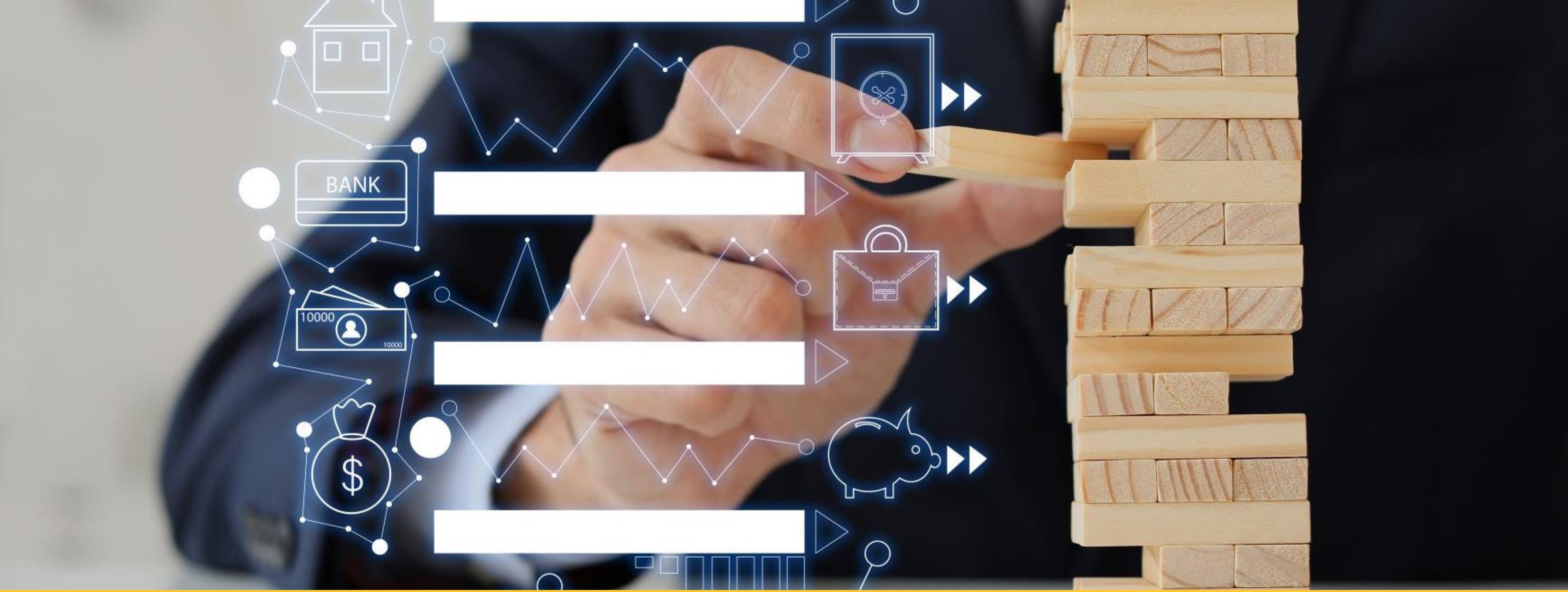
Thus, decline in total revenue will be relatively lower; stockbrokers also expected to engage pricing levers to offset the revenue loss

Exhibit 10: Potential range of decline in net operating income if F&O volumes revert to levels seen during FY2022-FY2023^



- Impact on digital brokers to be more prominent due to higher dependence on F&O segment and revenue loss because of implementation of 'true to label' charges
- Stockbrokers would require to recalibrate their business models, including upward revision in brokerage fees and a possible shift from brokerage-free products to maintain their profitability. As per ICRA's assessment, ceteris paribus, a 25% hike in F&O pricing could be required to materially offset the revenue loss.

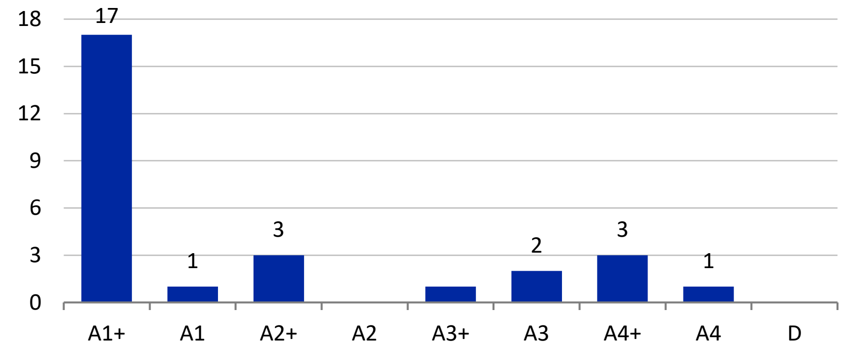
Source: ICRA Research; ^Note 1: Data not available for Broker 3 ; Note 2: vis-à-vis FY2024, assuming no price revision and second order impact on other segments; Note 3: Above impact analysis also captures impact due to implementation of 'true to label' charges



Annexure

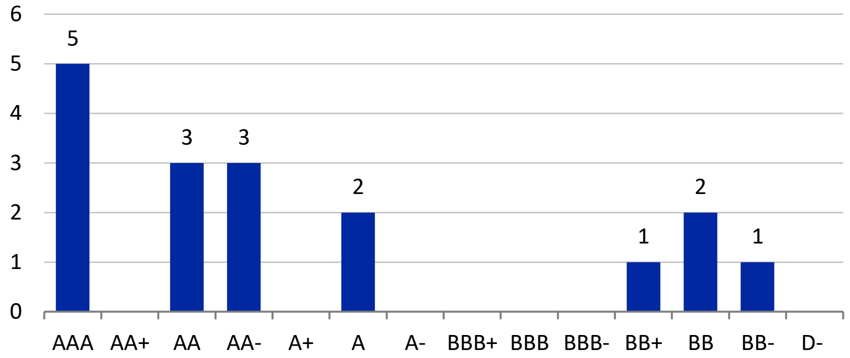
ICRA's coverage of brokerage industry

Exhibit 11: Distribution of ICRA's short-term ratings for brokerage companies^



Source: ICRA Research; ^ As of September 30, 2024

Exhibit 12: Distribution of ICRA's long-term ratings for brokerage companies^



Source: ICRA Research; ^ As of September 30, 2024

- ICRA has ratings outstanding on 31 brokerage companies.
- Of these, ICRA has long-term ratings outstanding for 17 companies while 28 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.
- Rating on a securities broker was upgraded in H1 FY2025 due to healthy improvement in its earnings profile aided by the increase in scale of operations.

ICRA-rated securities broking entities – I

Exhibit 13: List of ICRA-rated securities broking entities^ – I

Company Name	Long-term (LT) Rating	Outlook on LT Rating	Short-term (ST) Rating
Angel One Limited			[ICRA]A1+
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 of September 30, 2024; *Issuer not cooperating*

ICRA-rated securities broking entities – II

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Exhibit 14: 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 of September 30, 2024

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Thank You!