



This methodology note stands superseded. Refer to ICRA's website www.icra.in to view the updated methodology note.

Rating Methodology for Brokerage Houses

Stock Brokerage Houses perform an important role in the capital market by facilitating trades for all categories of investors. The role of intermediaries like Stock Brokerages is critical in developing a capital market structure that is fair and stable, while providing adequate liquidity to the market. With Indian equity broking industry being a highly fragmented industry having more than 37,000 brokers and sub-brokers active on various Exchange Houses, investors have a large range of such intermediaries for undertaking transactions on the exchange houses. Indian stock brokerage industry is also characterised as very dynamic and volatile for being dependent on the capital markets. While brokerage houses have reported significant improvement in their financial performance over past few years (especially between FY05 – FY08), they have seen one of the worst phases for capital market during FY08-09 which has surfaced their vulnerability to the various business risks associated with equity broking.

ICRA's rating methodology for Stock Brokerage Houses provides an analytical framework that focuses on the key operational, financial and qualitative factors that ICRA believes to be most critical in assessing its overall performance, competitive positioning and its ability to withstand challenging operating environment & service its debt obligations. ICRA's rating methodology is not based on any mathematical formula, instead involves an in-depth analysis of several qualitative and quantitative factors. In ICRA's view, the analysis of financial ratios alone (based on annual reports) would not be able to capture the entire business risks associated with stock brokerage houses, unlike commercial banks and non banking financial companies.

The current rating methodology is not an exhaustive list of the factors reflected in ICRA's rating, as the factors are continuously modified to capture the structural changes in the industry, but it should enable a broking company to benchmark itself on these key considerations used by ICRA while assigning a credit rating. For the rating of a stock brokerage house, ICRA also considers all other group companies engaged in various capital market related business activities as in ICRA's view, their revenues and business operations would be highly inter-linked. While ICRA would evaluate a broker's performance against all these critical factors before assigning an overall rating, special emphasis may

be placed on some of them, depending on the operating profile of the broker being rated and the nature of instrument.

ICRA's methodology comprises an analysis of the following factors: -

Sr. No.	Factors	Sub-factors
1	Operating Environment	Market Dynamics Competitive Dynamics
2	Management Quality	Promoters Quality Stability & Experience of top Management. Liquidity Management. Independence of the Board of Director. Corporate Governance. Accounting Quality Regulatory Compliance.
3	Business Infrastructure	Robustness of IT system. Adequacy of Management Information System Strength of Back Office Operations.
4	Risk Management	Risk Governance Management of Market risk. Management of Credit risk. Management of Operational risk.
5	Financial Strength	Earning Strength and Stability. Asset Quality. Capitalisation & Liquidity Profile.

Each of these factors is discussed at length in the following sections.

Operating Environment

A Brokerage House's performance is closely linked to the domestic capital market which in turn is exposed to various macro and micro factors. For a highly dynamic and un-predictable industry like a brokerage sector, operating environment plays an important role in evaluating overall credit profile of a Brokerage House and ICRA assesses the same for brokerage houses on the following parameters:-

Market Dynamics

This captures the favourability of operating environment for capital market related business operations. If a capital market is conducive, which is characterised by increasing industry brokerage turnover, rising Indices levels, more number of IPOs and investment banking deals, this would help a brokerage firm improve upon 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 company's financial performance but it would also put concerns on its own capital due to credit risk and market risk associated with brokerage business. While assigning a rating, the focus is generally on the long term trends rather than the impact of any short term volatility.

Any structural change imposed by regulatory bodies can also have a bearing on credit rating of the brokerage houses.

Competitive Dynamics

A competitive operating environment 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 company's profitability margins and requires constant innovation for maintaining its margins. Indian equity broking industry in particular is highly fragmented with more than 37,000 brokers and sub-brokers active in the market. While businesses like retail broking and arbitrage trading is highly fragmented other activities like institutional broking, investment banking, distribution, and also capital market related funding is limited to few big players only.

This factor in ICRA's framework for analysing brokerage houses captures company's ability to overcome the competition for growing its business volumes and ability to attract & retain key employees. In ICRA's view, 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, any other company having presence in investment banking and institutional broking is expected to face little competition as it is 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. Further, in ICRA's view, a brokerage house with large scale of operations would have a better resilience in economy downturns as compared to the brokerage houses with small scale of operations.

ICRA's approach to analyse company's competitive dynamics is to look separately into its each line of business like retail equity broking, institutional equity broking, commodity broking, debt broking, capital market related funding activities, advisory services, distribution of financial products, arbitrage & proprietary trading and underwriting. The competitive dynamics in each line of business is analysed on the following parameters: -

- Extent of diversification of 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. While a more diversified service provider would be able to provide a wider range of service to its clients, it will also require more committed resources in each service category.
- Share of business from various activities and correlation between segments. Since the securities business is cyclical, a high correlation among various businesses of a securities firm would tend to introduce high cyclical in its income.
- Proportion of revenues and profits from various activities and their stability. A securities firm's business being highly volatile, a higher proportion of relatively stable cash flows would help sustain operations during cyclical downturns.
- Extent of customer diversification (customer types would include proprietary, retail, high net worth individuals, and institutional), and stability of income from various client sets.
- Proportion of day trading clients. A very high proportion of day trading business would increase volatility in earnings.
- Spread of business among various institutional clients. High dependence on few clients would increase business risks.

Management Quality

With the dynamic nature of domestic capital market, Management quality for the equity brokerage sector is of utmost importance in ICRA's framework for assessing the broker's quality rating. While it's easy for the brokerage houses to scale up their business operations during the booming capital market, in ICRA's view, only strong management would help the company sail through stressful times. ICRA assesses the management quality on the following factors: -

Promoters Quality

ICRA's framework involves reviewing the promoter's track record in terms of growth of the business, risk appetite, gearing policy, transparency in running the operations and their commitment and financial support to the business in distressful times. Conservative business growth with no history of litigations or regulatory fines would be viewed favourably by ICRA over an aggressive business growth by compromising on the business ethics. In ICRA's view, companies backed by strong institutions as a strategic investor are expected to derive higher comfort as compared with any other company which is backed by individual promoters.

Stability and Experience of top Management

ICRA's framework evaluates the stability of the top management, their experience in capital market business operations and their track record to successfully respond to changes in industry dynamics. ICRA also analyses company's ability to attract and retain talent, frequency and quality of the training imparted to the employees and a well laid out succession plan for the top management. 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 would be viewed favourably by ICRA.

Liquidity Management

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 would be 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 unfavourably.

Independence of Board of Director

While the independent representation at board level provides a third party perspective and valuable inputs to the company's financial and business strategies and corporate actions; it also helps in protecting company's stakeholder's interest by assessing the associated critical risks and managing the company's integrity. ICRA's framework analyses the depth of the board of directors, their participation in the Board's meetings, and their independence from the daily operations.

Corporate Governance

ICRA's analysis of corporate governance practices prevalent in a company reflect 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. The emphasis of ICRA's analysis is on the corporate business practices and quality of disclosure standards that address the requirements of the regulators and are fair and transparent for its financial stakeholders.

Accounting Quality

Adherence to proper accounting practices and transparency in disclosures are critical attributes, and the extent of the same are assessed while taking a view on the current financial health and potential risk factors of a stock broker. Specifically, ICRA would examine the factors like quality of audit, quality of disclosures, transparency of accounting policies, accounting policy followed for derivative instruments and proprietary trading, and existence & reporting lines of an internal audit department for evaluating the adequacy of a brokerage's accounting quality standards.

Regulatory Compliance

The rules and regulations applicable to stock brokerages, besides being statutory, play an important role in curbing aggressive risk taking 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. Specifically, the following aspects, among others, are analysed:

- Compliance with various Acts, Rules, Guidelines and by-laws including The Companies Act, 1956; The Securities Contracts (Regulation) Act, 1956; The Depositories Act, 1996; SEBI (Stock broker & sub-broker) Regulation, 1992; Rules, Regulations, By-laws of the respective Stock Exchanges; and By-laws and Business Rules of the respective Depository Participants (DPs).
- 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.
- History of litigation by retail and/or institutional clients.
- Management attitude towards client-related statutory requirements, like maintenance of client details and margin collections, and systems to monitor the same.

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 Houses 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:

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Robustness of the IT systems

ICRA analyses the adequacy of infrastructure as required to comply with the requirements of regulators/Stock Exchanges, etc, adequacy of connectivity with the exchange houses, communication network and there redundancy levels with branches & sub-brokers, system's un-utilised capacity & its scalability, time taken to restore the connection failure, database maintained, policy on disaster house for maintaining clients transaction history and efficient real time margin monitoring system 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. Broker's with proven track record of scaling up its business operations without any major disruption due to technical snags would provide comfort to ICRA's overall assessment.

Adequacy of Management Information System

In ICRA's view robust Management Information System (MIS) plays a crucial role for a brokerage house in monitoring branch efficiency, utilisation of the capital placed with the exchange houses, monitoring dealer limits, client limits besides ensuring smooth running of the normal business operations. Accordingly, ICRA's framework would evaluate the quality and timeliness of the reports generated through the MIS system and its relevance for the broker in improving upon its business performance.

Strength of Back Office Operations

Back office operations serves as a back bone of a brokerage house 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 Houses 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. Broker'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 broker's back office operations comprises of assessment of the processes, quality of the data captured, storage facility, and the extent of automation.

Risk Management

Brokerage houses 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 house 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 broker's risk management systems on the following parameters: -

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 independency of the risk management team. In addition to the above factors, companies doing regular stress testing and upgrading their systems accordingly are also viewed favorably.

Management of Market risk

The analysis of broker's exposure to market risk encompasses the mix of proprietary trading versus customer-oriented trading, variability of the trading returns, quantification and reporting of the market risk, risk appetite & hedging strategies, and concentration 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 house with small

proprietary book as a proportion of overall asset size, risk based trading policy, policy based conservative exposure limits & margin cover and auto-square off mechanism in the event of margin shortfall would be viewed favorably by ICRA.

Management of Credit risk

ICRA credit risk analysis evaluates the credit appraisal procedures for approving new clients and new franchisee and the initial deposit requirement, setting up of country-party limits, margin call policy, efficiency of the follow ups in case of margin shortfall, arrangement with the franchisee for the recovery of outstanding debt on account of franchisee's clients, procedures for approving under-writing deals or merchant banking investments, and concentration of business with any particular client.

Management of Operational risk

As a routine business operation, brokerage houses 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 broker'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

With the booming capital market over last few years, brokerage houses have significantly improved upon their financial performance. Riding on the buoyant capital market, many brokerage houses have also raised capital either through IPO route or through private equity placement over past years (FY06-07 and FY07-08). However with the significant market correction in January 2008, environment has become very challenging for the brokerage houses and subsequently their profitability has come under pressure.

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

Earning Strength and Stability

ICRA's framework examines the company's ability to maintain its profitability through economic swings and ability to generate adequate return on network. In order to capture company's scale of operations, franchisee strength and competitive positions ICRA analyses pre-tax earnings which in ICRA's view also provide 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, with the most recent year receiving higher weightage.

In order to analyse the company's ability to generate revenues while keeping the expenses under check, ICRA analyses pre-tax margins¹. A Company having large company owned retail network, expensive manpower, high lease rentals, inefficient processes and company in an expansion phase is expected to have lower pre-tax margins as compared with any other player having franchisee operated retail network or having presence in only institutional equity broking, diversified earning profile utilising the resources and less expensive man-power. Brokerage houses 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

¹ Defined as Profit before tax / Total income (brokerage income and trading income taken on net basis)

in excessive trading. This ratio is also analysed by using weighted average of pre-tax margins for last three years, with the most recent year receiving higher weightage.

For analysing company's ability to maintain its profit margins irrespective of the operating environment, ICRA examines pre-tax margin volatility calculated by coefficient of variation² of pre-tax margins for five years. This ratio becomes even more important for the brokerage houses as their profitability depends on capital market which is characterised as highly dynamic. Any extra-ordinary items are ignored while calculating the margin volatility. In ICRA's view, companies only involved in advisory services may have high pre-tax margins, however its pre-tax margins could be very volatile.

Asset Quality

It is of prime importance for the brokerage houses 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 business as a percentage of company's networth and also as a percentage of operating income³ for past several years.

However, in the absence of any stringent regulatory credit provisioning policy, it is difficult to assess the company's asset quality on the basis of the financial indicators alone. For the same, ICRA also analyses track record of the company in maintaining sufficient margin cover of accepted collateral on their top clients during the highly volatile period.

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 broker.

For analysing broker's adequacy of funds, ICRA evaluates the parameters like 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. Brokerage houses with proven track record of maintaining sufficient capital with the Exchange House with no history of shutdown of broking terminals or they being put in square-up mode on account of margin shortfall would be viewed favourably by ICRA. The rating framework also evaluates broker's capital adequacy for the current business operations and its ability to raise further funds for business expansion. In ICRA's view, strong capital levels provides necessary cushion in terms of absorbing any delay in collections from clients and losses during bad capital market. However, ICRA evaluates the company on the basis of free networth available for the business after adjusting it for risky or ill-liquid investments.

Brokerage houses 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 company's actual gearing, ICRA also considers the bank guarantees as a part of external debt programme.

² Defined as standard deviation / mean of population.

³ 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.



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