RATING METHODOLOGY FOR STOCK BROKING FIRMS

Stock Broking Firms 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 the ending of the war, the Sri Lankan equity broking industry has seen significant progress, including increases in services provided and the number of players in the market. The stock brokerage industry is also characterised as very dynamic and volatile for being dependent on the capital markets. While broking firms in general have reported significant improvement in their financial performance since the ending of the war, over the past few years, they have also seen some of the worst phases for capital market, which has highlighted their vulnerability to the various business risks associated with equity broking.

ICRA Lanka's rating methodology for Stock Broking firms provides an analytical framework that focuses on the key operational, financial and qualitative factors that ICRA Lanka 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 Lanka's rating methodology is not based on any mathematical formula, instead involves an in-depth analysis of several qualitative and quantitative factors. In ICRA Lanka'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 broking firms, unlike commercial banks and non banking financial companies.

The current rating methodology is not an exhaustive list of the factors reflected in ICRA Lanka's rating, as the factors will be 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 Lanka while assigning a credit rating. For the rating of a stock broking firm, ICRA Lanka also considers all other group companies engaged in various capital market related business activities as in ICRA Lanka's view, their revenues and business operations would be highly inter-linked. While ICRA Lanka 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 Lanka's methodology comprises an analysis of the following factors

Serial 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.

OPERATING ENVIRONMENT

A Broking firm'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 Broking firm and ICRA Lanka assesses the same 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, un-favourable 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 broking firms.

Competitive Dynamics

A competitive operating environment can have a deep impact on broking firm's 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. .

This factor in ICRA Lanka's framework for analysing broking firms captures company's ability to overcome the competition for growing its business volumes and ability to attract & retain key employees. In ICRA Lanka'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 institutional broking and linked to investment banking is expected to face lower competition. Further, in ICRA Lanka's view, a broking firm with large scale of operations would have a better resilience in economic downturns, as compared to the broking firm with small scale of operations.

ICRA Lanka'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, debt broking, and its access to capital market related funding activities, advisory services, distribution of financial products, 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, debt 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 cyclicality 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 broking sector is of utmost importance in ICRA Lanka's framework for assessing the broker's quality rating. While it's easy for the broking firm to scale up their business operations during the booming capital market, in ICRA Lanka's view, only strong management would help the company sail through stressful times. ICRA Lanka assesses the management quality on the following factors: -

Promoters Quality

ICRA Lanka'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 Lanka over an aggressive business growth by compromising on the business ethics. In ICRA Lanka'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 Lanka'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 Lanka 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 broking firm 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 Lanka.

Liquidity Management

Companies which have a well defined policy of maintaining adequate liquidity in terms of un-utilised bank lines and or access to other sources of funding and do not have any problems with meeting/toping up the minimum liquidity deposit requirements of the Stock Exchange 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 to meet the settlement obligations that will arise particularly, during volatile periods. Any company which is frequently required to resort to unapproved overdrafts from the clearing banks is viewed un-favourably.

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 Lanka'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 Lanka'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 Lanka'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 Lanka 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 broking firm's accounting quality standards.

Regulatory Compliance

The rules and regulations applicable to stock broking firms, besides being statutory, play an important role in curbing aggressive risk taking and in enforcing discipline. The ICRA Lanka rating methodology not only examines the compliance record of the broking firm 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, The Securities and Exchange Act, The SEC regulations on market intermediaries and rules and regulations of the Colombo Stock exchange.
- History of non-compliance and severity of regulatory sanctions. History of penal actions by regulators/exchanges for violation of norms.
- 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. Broking firms with poor back-office infrastructure are likely to compromise both on risk management as well as client servicing. Thus, the ICRA Lanka rating methodology provides for a close examination of the following aspects: -

Robustness of the IT systems

ICRA Lanka analyses the adequacy of infrastructure as required to comply with the requirements of regulator/Stock Exchange etc, adequacy of connectivity with the exchange, communication network and there redundancy levels with branches, if any, 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 Lanka also evaluates the broker's focus on continuous improvement and ability to scale up its IT systems in line with the business growth. Brokers with proven track record of scaling up its business operations without any major disruption due to technical snags would provide comfort to ICRA Lanka's overall assessment.

Adequacy of Management Information System

In ICRA Lanka's view robust Management Information System (MIS) plays a crucial role for a broking firm in monitoring branch efficiency, if any, monitoring the liquidity requirements to meet the automated settlement obligations by the clearing banks, monitoring limits of investment advisers, client limits besides ensuring smooth running of the normal business operations. Accordingly, ICRA Lanka'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 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. Broking firms with poor back-office infrastructure are likely to compromise both on risk management as well as client servicing. The systems deployed have to be strong enough to be able to capture and report all the transactions of clients without any error. 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 Lanka'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

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

Risk Governance

ICRA Lanka'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 favourably.

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 Lanka 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 broking firm 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 favourably by ICRA Lanka.

Management of Credit risk

ICRA Lanka credit risk analysis evaluates the credit appraisal procedures for approving new clients and new franchisee and the initial deposit requirement, 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, broking firms are engaged in processing large number of transactions and transferring huge amount of cash and securities every day. For executing such large data based transactions, it is necessary to have efficient and smooth running internal control system. ICRA Lanka'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 the last couple of years, broking firms have significantly improved upon their financial performance. ICRA Lanka'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 Lanka analyses broker's business and financial strength on the following parameters: -

Earning Strength and Stability

ICRA Lanka's framework examines the company's ability to maintain its profitability through economic swings and ability to generate adequate return on networth. In order to capture company's scale of operations, franchisee strength and competitive positions, ICRA Lanka analyses pre-tax earnings which in ICRA Lanka'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 Lanka'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 Lanka analyses pre-tax margins[1]. 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. Broking firms with large proportion of variable cost would be more comfortable in protecting its pre-tax margins in stressful times. While calculating total income, brokerage income and trading income is taken on net basis so as to nullify the impact of bloated income for a Company largely operating through a franchisee model or engaged in excessive trading. This ratio is also analysed by using weighted average of pre-tax margins for last three years, with the most recent year receiving higher weightage.

For analysing company's ability to maintain its profit margins irrespective of the operating environment, ICRA Lanka examines pre-tax margin volatility calculated by coefficient of variation[2] of pre-tax margins for five years. This ratio becomes even more important for the broking firm 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 Lanka's view, companies only involved in advisory services may have high pre-tax margins, however it pre-tax margins could be very volatile.

Asset Quality

[1] Defined as Profit before tax / Total income (brokerage income and trading income taken on net basis)
[2] Defined as standard deviation / mean of population.

It is of prime importance for the broking firm to maintain stringent risk management framework and monitoring systems in order to limit any losses associated with a capital market related business operations. In order to capture a long track record of maintaining good asset quality, ICRA Lanka'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 income[3] 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 Lanka 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 firm needs to have an adequate level of capital to meet its operating requirements. Since sudden liquidity requirement is a possibility to meet settlement requirements, the ability to raise funds quickly is a distinct positive for a broker. For analysing broker's adequacy of funds, ICRA Lanka 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, collection period from the clients and capital needs of off-balance sheet transactions. . 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 Lanka'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 Lanka evaluates the company on the basis of free networth available for the business after adjusting it for risky or ill-liquid investments. Broking firms are expected to have low external borrowings, at-least on the balance sheet, as they normally place Bank Guarantees with the Stock Exchange to meet minimum liquidity requirements. Therefore for the analysis of company's actual gearing, ICRA Lanka also considers the bank guarantees as a part of external debt programme.

[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.