



Rating Criteria for Securities and Broking Firms

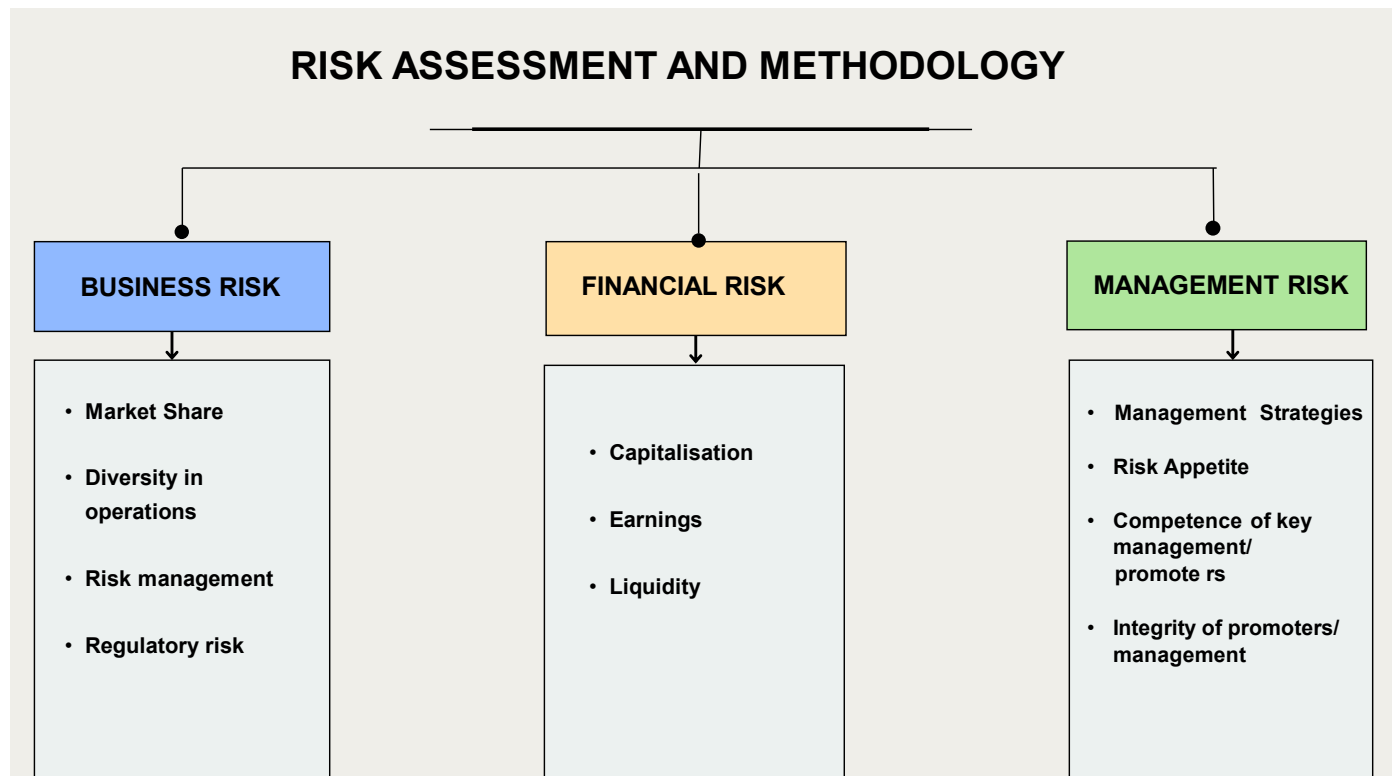
Executive Summary

In the Indian stock market, stockbrokers and securities firms function as intermediaries, helping investors execute transactions involving the buying and selling of securities and shares. The criteria apply to companies engaged in trading and underwriting securities, as well as those providing brokerage services in the financial sector. This category includes primary dealers, brokerages, and securities investment firms. Securities firms act as agents in the investment space. They provide fund-based services such as underwriting and trading in government securities and corporate debt, margin lending against these securities and fee-based services such as equity and debt broking and placement, asset management and advisory.

Scope of Criteria

Securities firms primarily are exposed to market risks since they hold securities largely for short durations, although they are also exposed to credit risks during this period. They also face large operational risks, especially in their brokerage business. The document provides a brief analysis of the key factors assessed by Brickwork Ratings (BWR) when assigning ratings to entities in the securities and broking industry. The risks are primarily categorized under Business, Financial, and Management risk parameters. This approach is designed to offer investors and stakeholders a clear insight into the potential risks and opportunities linked to the entity.

Risk Assessment and Methodology



BWR's framework for assessing the credit quality of securities and broking entities covers business risk, financial risk and management risk. Each of these broad risk factors are subdivided into various parameters, which may vary depending on the type of business.

These criteria outline the methodology to arrive at the standalone rating of a securities firm. The rating further considers any support that the entity can get from its parent or group or can be expected to provide to other entities in its group. In such cases, the standalone rating of the entity gets notched-up, and the extent of the notch-up is driven by BWR's criteria for notching-up the standalone ratings of entities based on parent/group/government support, which can be found on the BWR website

Business Risk

The business risk assesses how external and internal factors may impact the firm's ability to operate successfully and generate sustainable returns. These risks and process of managing the same are both complicated in securities firms. While market position is important in any financial institution, it carries a whole different meaning for securities firms. Moreover, risk management requires complex models and systems even for small entities in this business, and regulatory compliances can be onerous.

- **Market Share**

Brokerages depend on garnering market share to not only increase their revenues but also be able to invest in building other businesses to increase their offerings to get a larger share of the customer wallet. A larger market share also helps them build better research and advisory capabilities needed to attract high-net-worth individuals and also a share of the large institutional funds. The market share by segment is assessed, along with the number of branches, franchisees, active clients, and so on.

- **Diversity in Operations**

Growth beyond a certain size, and attracting large corporates and funds requires securities firms to offer a wide variety of business segments, viz., broking, distribution, investment banking and trading, and also a good spread of products, viz., brokerage accounts, margin funding, IPO funding, distribution, book building and underwriting.

- **Risk Management**

Given the myriads of risks that securities firms face in their different lines of businesses, an evaluation of the policies, models and processes adopted by the entity are analysed. Some of the key risks that need assessment and management at securities firms are market risks in investments, measuring VaR and interest rate sensitivity, trading limits for proprietary trades, margining and haircut policies for margin lending, and operational risks in brokerage accounts.

- **Regulatory Compliance**

The regulatory compliances for securities firms are also complex and need comprehensive risk management tools and MIS to meet the necessary compliances. The state of preparedness of the entity to meet the above requirements is assessed by BWR.

As prescribed by SEBI, the client agrees to pay the stockbroker the applicable brokerage fees and statutory levies for their account, transactions, and services. The stockbroker will not charge more than the maximum brokerage allowed under the rules of the relevant stock exchanges and SEBI regulations.

Financial Risk

Financial Risk for securities and broking firms refers to the potential financial challenges that could affect a firm's ability to meet its financial obligations and maintain stability. This includes various factors related to the firm's financial health. Key elements of financial risk include capitalization, earnings and liquidity short-term requirements.

- **Capitalisation:** A well-capitalized firm has enough equity and reserves to handle market fluctuations, financial stress, and unexpected losses, ensuring stability. Adequate capitalization strengthens a firm's capacity to expand, invest in infrastructure, and comply with regulatory standards, thereby boosting investor confidence and market credibility. The entity's gearing, management commitment to limit gearing over time, and the entity's ability to raise capital are key factors. Entities with larger proprietary positions typically have higher capital requirements.
- **Earnings:** The earnings of securities firms are volatile and are dependent on the performance of the markets. Diversity in businesses and product offerings is used by entities to smoothen the earnings. In addition, an assessment of the quality of earnings is done. Entities that have higher earnings from proprietary trading are vulnerable to losses during a market underperformance.
- **Liquidity:** Liquidity maintained through liquid assets and unutilized limits available for any short-term requirements is important for trading entities. For securities and broking firms, maintaining adequate liquidity is vital for day-to-day operations, such as settling client transactions and margin calls. Strong liquidity enables firms to navigate market fluctuations and unexpected financial stress, meeting obligations without relying on external financing or asset sales at a loss.

Management / Governance Risk

Management strategies on growth, business segments and products, risk appetite for proprietary trading, competency related to risk management, systems and models implemented are evaluated to assess the management's ability to run the entity.

- **Management Strategies:** Management strategies under management risk evaluate how effectively a securities and broking firm's leadership guides the company toward its objectives. This involves decision-making quality, strategic vision, risk management, and adaptability to market changes. Strong management ensures long-term growth and stability, while weak leadership can lead to inefficiencies, regulatory problems, and financial losses. Effective leadership is essential in navigating the complex financial sector.
- **Risk Appetite:** The risk appetite refers to the degree of risk a securities and broking firm is prepared to take in order to reach its objectives. It defines the firm's tolerance for financial, market, and operational risks. A well-defined risk appetite allows the firm to make balanced, informed decisions, aligning potential returns with acceptable risks. If mismanaged, it can lead to either excessive exposure or overly conservative approaches, negatively impacting growth and profitability.
- **Competence of key management / promoters:** It assesses the leadership's skills, experience, and capability to make sound decisions and execute strategies. Effective leadership drives stability and growth, whereas weak management can result in inefficiencies and financial challenges.
- **Integrity of promoters/management:** It evaluates the ethical standards, transparency, and honesty of a firm's leadership, ensuring management acts in the firm's best interests and adheres to legal and regulatory requirements. Strong integrity fosters trust and stability, while unethical behaviour can result in reputational harm and financial setbacks.

In addition to the mentioned risks above, BWR also believes Environmental, Social and Corporate governance (ESG) risks and opportunities can increasingly have an impact on the operations and sustainability of business of an issuer. Hence, BWR while assessing the credit profile also assesses the ESG profile of the issuer based on data availability. It may be noted that the impact of the ESG profile of the issuer, both in terms of its strengths and weaknesses, is incorporated into the various management risk related parameters while assessing the credit risk associated with the issuer entity.

Conclusions

BWR performs a comprehensive assessment of the entity, analyzing its business, financial, and management risks to determine its overall credit quality. A firm that excels in these areas demonstrates effective risk management, strong profitability, and long-term sustainability, making it a reliable investment. Conversely, weaknesses in any of these factors could indicate potential risks and uncertainties, which may erode investor confidence and hinder the firm's success in the competitive financial market.

The previous version of this document can be found in

<https://www.brickworkratings.com/download/Securities-and-BrokingFirms-Jun2021.pdf>

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