

CRISIL's Criteria for Broker Quality Grading

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Criteria contacts

Pawan Agrawal

Chief Analytical Officer – CRISIL Ratings
Email: pawan.agrawal@crisil.com

Sameer Charania

Director – Rating Criteria and Product Development
Email: sameer.charania@crisil.com

Somasekhar Vemuri

Senior Director – Rating Criteria and Product Development
Email: somasekhar.vemuri@crisil.com

Ankit Dhawan

Senior Rating Analyst – Rating Criteria and Product Development
Email: ankit.dhawan@crisil.com

In case of any feedback or queries, you may write to us at criteria.feedback@crisil.com

Broker quality grading

With the widespread interest in the stock markets, and the availability of a number of brokers and sub-brokers, investors today have a large range of intermediaries through whom they can transact on the stock exchanges. It is in the interest of investors to hire brokers on the basis of the range and quality of services they provide. CRISIL's Broker Quality Grading is designed to help investors differentiate between brokers on the quality of service.

Definition and scale

A CRISIL Broker Grading is an opinion on the quality of operations and service provided by the graded stock broker. The grading is expressed on a five-point scale, 'BQ~1' signifying the highest quality of service, and 'BQ~5' the lowest.

Validity of the grading

The grading will be valid for a period of one year from the date of issue; CRISIL reserves the right to change the grading during the validity period if it deems necessary. At the end of one year, if the graded broker desires, a review will be carried out and a fresh grading assigned.

Unique character of the broking industry

The broking industry rides on extreme time and information sensitivity. Investors may wish to put through transactions quickly. They will look for assurance that the transactions will be completed satisfactorily and without fail. To provide such an assurance, it becomes necessary for a broker to adopt processes and practices that ensure customer servicing is prompt and adequate. Such servicing should be backed by robust systems that provide the necessary channels through which investors can interact with the broker swiftly and securely. The need to ensure speed and reliability on a sustained basis, in a business characterised by increasing volumes, require strong processes and practices backed by efficient use of technology.

The broker is also exposed to large counterparty risk between the time the deal is put through till the payment/delivery is made by the client. Unless the broking house has a good margining system which is strictly implemented, there is a possibility that the failure of a single client can potentially cascade into losses for other clients. Broking houses need to have robust risk management policies in place to manage this risk.

Continuity of service is also dependent on strict compliance with existing laws. Given the high degree of economic sensitivity, SEBI, BSE, NSE, and other regulators often deal sternly with deviations from the rules and regulations. In cases of infraction of rules, the regulator may order terminals to be locked, or trading to be suspended. The broker's intent and capacity to abide by the applicable rules and guidelines, therefore, become important.

Trading on own account increases the broking firm's risk profile; it also increases the likelihood of diversion of client funds and stocks to meet margin requirements. Although such activity does not affect investors under normal circumstances, it subjects broking houses to undue stress in the event of sudden price movements. If the broking house is not able to raise adequate resources in time to overcome such stress situations, the liquidity problems it may subsequently get into, could compromise its clients' interests.

The grading process

CRISIL uses the key parameters listed in Table 1 to assess the quality of operations of a broking firm and the services offered by it. Each parameter is assessed individually; these assessments are then aggregated to arrive at the final grading.

Table 1: The key parameters and their constituents

| Sr No | Risk Parameter |
|--------------|--|
| 1 | Customer Relationships Systems Framework |
| 2.a | A) Process and procedures |
| 2.b | B) Use of technology and level of sophistication |
| 3 | Management of market risk |
| 4 | Compliance quality |
| 5 | Management quality |
| 6 | Business strength and financials |
| 6.a | Business strength |
| 6.b | Financials |
| 7 | Own account trading |

Individual risk parameters and what they measure



Customer Relationships: The standard practices followed by the broker in servicing clients are evaluated. This helps assess the adequacy of these practices and the extent to which they are implemented. Transparency in dealings with clients (investors), and the nature of value-added services provided (such as research/news updates and investor education programmes) and of products offered (such as portfolio management services) are among the key parameters that CRISIL evaluates.

Systems Framework: For the broker to be able to service clients effectively and efficiently, the systems backbone needs to be robust. The systems deployed will have to be capable of capturing, processing and reporting all transactions of all clients with a zero or near-zero error rate. CRISIL's evaluation of the systems framework consists of an assessment of the process and procedures deployed and the extent of automation. The systems assessed include risk management systems, soft solutions deployed to ensure compliance and adherence to know-your-client (KYC) norms, and the quality of the reports generated by the MIS

Management of Market Risk: A broking firm may be exposed to large counter-party risks between the time the deal is put through on the exchange and the time the payment/delivery is made by the client. Managing this risk is important because the failure of a single client can potentially cascade into losses for other clients. The broking house's market risk exposure is contained by a system of exposure limits and margin requirements. CRISIL's

grading team assesses the robustness and reliability of the risk management systems. The grading team evaluates the reliability and comprehensiveness of the mode and manner of margining and margin tracking, and also the measures adopted to assess the credit risks of clients (based on which margining requirements are decided).

Legal Compliance: Legal compliance is very important in the broking industry due to the stringent implementation of rules by the regulators and the possibility of suspension of operations if rules are breached. CRISIL assesses the internal control measures adopted to ensure adequate legal and regulatory compliance. An objective assessment of the attitude of management towards legal compliance and the systems set in place to ensure compliance provide assurance that the broker's service continuity will not be affected by the regulator's penal action. Compliance levels are examined in detail, especially with regard to fines and penalties and general censures imposed by the regulators.

Management Quality: CRISIL assesses the strength of the organisational structure and its ability to effectively streamline operations to meet customer needs. The promoters' reputation and track record of profitably managing operations are also assessed. The grading team assesses the availability of experienced and competent personnel to perform and manage the firm's daily operations. The risk appetite of the promoters/top management is also assessed.

Business Strength and Financials: The broking house's business strengths and financial soundness are assessed to ascertain the sustainability of its operations. Broking businesses derive strength from diversity of revenue streams; firms that are not dependent on a few major players, and therefore, have low concentration risk, are better placed. The various avenues of income and their trends are assessed along with other key parameters such as market share and client profiles. In order to assess the financial soundness of broking houses, CRISIL evaluates indicators such as capital adequacy and overall leverage.

Own Account Trading: Own account trading increases the broking firm's risk profile; it also increases the likelihood of diversion of client funds and stocks to meet margin requirements. Such activity does not affect investors under normal circumstances, but it subjects broking houses to undue stress in the event of sudden price movements. If the broking house is not able to raise adequate resources in time to overcome such stress situations, the liquidity problems it may subsequently get into could compromise its clients' interests. CRISIL assesses the controls/limits adopted by the broker in own account trading, and judges the relative risks involved.

The Final Grading: After evaluating the broking house on the identified risk parameters, and the information gathered during interactions with the management, CRISIL's rating committee discusses the case and determines the final grading. The assigned grading is communicated to the broking house and, if accepted, is made public by CRISIL.

For accessing the previous published document on 'CRISIL's Criteria for Broker Quality Grading', kindly refer to the following link: https://www.crisil.com/Ratings/SectorMethodology/MethodologyDocs/CRISIL-Ratings-criteria-broker-quality-grading_2007-28062017.pdf

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