Rating criteria for securities firms

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Executive summary

CRISIL rates securities firms, such as primary dealers (PDs) and brokerages, for their long-term and short-term debt and commitments to counterparties. The analytical framework discussed here applies to the securities-related businesses of banks and other financial institutions as well.¹

Securities firms essentially act as agents or principals. Their business encompasses fund-based activities (such as government securities underwriting and trading, corporate debt underwriting and trading, and margin lending) and fee-based ones (for instance, equity and debt broking, equity and debt placement, advisory services and asset management).

Securities firms face market risk (arising from fluctuations in security prices or interest rate) and counterparty risk. For retail brokers, the large daily transaction volume entails operational and legal risks. Unlike for commercial banks and financial institutions, analysis of the balance sheets and financial ratios of securities firms does not entirely capture their risk profile. That’s because the key risks these firms face are market and business risks, which are volatile and difficult to measure from year-end reports.

Hence, it is necessary to factor in the systems and processes put in place by these firms to mitigate these risks, as well as their ability to absorb losses arising from any adverse market movement.

CRISIL’s evaluation of securities firms comprises an analysis of:

- **Business risk**
  - Market position
  - Risk management systems (RMS)
  - Resources
- **Financial risk**
  - Capital position
  - Earnings
  - Liquidity
- **Management risk**

Business risk

A securities company’s business risk is a function of the inherent volatility, cyclicality and unpredictability of the industry, the company’s market position across business segments, and diverse environmental factors. CRISIL tracks developments in the securities industry and gauges their impact on business conditions.

CRISIL’s approach to analysing a securities company’s risk profile is to deconstruct its operations into its various lines of business, such as government securities underwriting and trading, corporate debt underwriting

¹ For accessing the previous published document on ‘Rating criteria for securities companies’, kindly refer to the following link: https://www.crisil.com/content/dam/crisil/criteria_methodology/financials/archive/CRISIL-Ratings-criteria-securities-companies-july2017.pdf
and trading, debt broking, equity broking (retail and institutional), equity trading, and investment banking. Many securities firms have a dedicated quant desk to trade using algorithms for institutional clients or on their own books (proprietary trading). As these algorithms run with minimal human intervention, operational risks arising due to improper input (fat finger error) or algorithm malfunctioning (runaway-loop situation) need to be addressed.

The risk profiles of the individual business lines are evaluated in terms of inherent business risks, the company’s market position and its stability, track record, systems and processes (including RMS), skill of the staff, profitability, funding profile and the risk culture. The risk profiles of the individual businesses are then aggregated, not necessarily by an additive process.

A company with diverse businesses that are counter-cyclical to one another may achieve a lower aggregate risk profile. External factors such as regulations, state of the economy, government borrowing programme, capital needs of the corporate sector, and liquidity in the capital and money markets also have a direct bearing on business potential.

**Market position**

While there are only a few PDs, the broking business is highly fragmented and has various segments (such as cash and future & options [F&O]). The entity’s market share in each segment is evaluated. Branch and franchisee network play a key role in enhancing market position. Sustainability and scalability also assume importance, as they ensure fixed costs are distributed better and bring in additional revenue streams such as distribution income. Other factors include the client mix (in terms of retail, high networth individuals [HNIs] and institutional) and the proportion of active clients.

**RMS**

In its assessment of RMS, CRISIL evaluates business-specific systems, policies and practices as well as those pertaining to the general operations of the company.

Through management discussions and client interaction, CRISIL ascertains the risk policies and how well they are adhered to.

Securities companies face numerous risks, including market, credit, operational, legal, regulatory, and business risks. While some risks can be quantified, CRISIL goes beyond quantitative parameters to evaluate whether the company has taken appropriate steps and established systems to address the risks.

CRISIL assesses a securities company's ability to define, measure, monitor and control market, credit and operational risks and lay out clear guidelines for traders and staff. The independence of the risk management process—in terms of reporting lines and ability to overcome subtle pressures to co-opt its independence—is very important. In this context, the following factors are analysed:

2 Presents only an indicative list of factors considered by CRISIL
### Business segments

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<th>Business segments</th>
<th>RMS factors assessed</th>
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| **Equity broking, loan or margin against shares** | - Margin policy – Stated margin policies and practices followed by the company, including the thresholds beyond which exposures will be automatically squared off.  
  - Debtor policy – What is the policy regarding collection of dues from clients?  
  - Hair-cut policy – While extending margin or loans against shares in the client’s depository account, what kind of hair-cuts does the company apply? Are they as stipulated by regulations? |
| **Proprietary trading**                        | - Factors taken into account while assigning limits to a trader  
  - Systems to prevent traders from exceeding limits or breaching securities they are allowed to invest in |
| **Primary dealership**                         | - Models used for measuring and reporting market risks  
  - Capital adequacy to absorb the impact of market-related factors and interest rate shocks |
| **Operational risk assessment**                | - Systems and processes to implement risk management policies. This includes real-time monitoring of exposures, automation of margin calls, and squaring off of exposures.  
  - Organisational structure and decision making that enables independence of risk management functions; autonomy granted to the risk management function from the trading desk  
  - Business continuity/ disaster recovery plans  
  - Adherence with compliance policies, such as know-your-customer and anti-money laundering policies  
  - For brokers engaged in algorithmic trading, whether systems and the associated infrastructure have been audited by the exchange, or if there have been materially adverse observations in the systems audit report |

CRISIL notes that the models to evaluate market risks and the assumptions underlying the models are not standardised across Indian securities firms. For instance, the different risk monitoring tools used by debt traders include calculation of modified duration of the portfolio (weighted average maturity), value at risk calculations, and daily earnings at risk calculations. Similarly, sensitivity to interest rate is measured by using various types of interest rate shocks by different debt traders: some consider a non-uniform shift in yield curve while others assume a uniform (or parallel) shift. As a result, CRISIL closely analyses the market risk models used by debt traders and looks at the result of back testing these models with actual historical data. This is done to assess the efficacy of the models.

### Resources

It is important that funding sources for securities firms be diversified in terms of fund and non-fund based avenues. PDs, given the nature and tenure of their investments, typically rely on short-term borrowings, including systemic sources of funding. Broking firms borrow mainly for margin requirements and rely on non-fund-based or short-term borrowings. Having multiple investor/lender relationships ensures there is no excessive dependence on a single funding source.
Financial risk

CRISIL assesses the financial risk associated with a securities firm on three parameters: capital position, earnings and liquidity. The amount of capital in relation to business size is an important indicator of the ability to absorb losses. Earnings indicate the efficacy of the cost structure. Liquidity is critical to meet short-term needs.

Capitalisation

CRISIL assesses a securities company's capital position in conjunction with its risk culture. The extent of proprietary trading vis-à-vis capital is also a critical factor. A large networth provides the strength to withstand shocks from trading and other losses.

The traditional methods of measuring capitalisation, such as gearing (debt-to-equity ratio) have limitations in realistically reflecting capitalisation of securities firms. Therefore, for PDs and brokerages, CRISIL uses networth coverage in addition to the traditional capitalisation metrics.

For PDs, the Reserve Bank of India (RBI) has stipulated a minimum capital adequacy of 15% of risk-weighted assets (RWAs). This takes into account the underlying credit risk as well as market risk (based on the value-at-risk approach). PDs have the flexibility to use their own internal risk management framework or adopt the standardised approach prescribed by the RBI for arriving at RWAs. Additionally, CRISIL takes into account the ability to withstand a shock to interest rates\(^3\), that is, networth coverage for portfolio losses assuming a 100 basis point parallel shift in yield curve.

For brokerages, CRISIL may evaluate the networth available to set off losses at a short notice. Therefore, fixed assets, doubtful debts and similar such illiquid assets are excluded.

Earnings

The volatility, cyclical and unpredictability of the industry is best reflected in the earnings of securities firms. To get a true sense of the size and stability of a firm’s returns, CRISIL examines performance over a longer market cycle period. It is essential to examine these returns in light of the company’s risk appetite.

Better-managed firms handle the inherent volatility by diversifying into different segments and controlling their fixed cost. Therefore, CRISIL focuses on the cost to income ratio of these companies on a steady state basis. This ratio indicates the ability to counter the volatility in income streams inherent in the business. Hence, CRISIL’s analysis includes an understanding of the management’s strategy to address the inherent volatility.

Liquidity

Securities businesses are based on confidence—even a perception of trouble in the market can impact a company significantly. To the extent that the firm depends on confidence-sensitive financing, it is exposed to the risk of funding disruptions. Many firms manage this risk by maintaining adequate alternative liquidity (in the form of unencumbered assets) that can be quickly pledged in return for secured loans. Many also maintain committed bank lines. To be effective, these sources require good operational systems that permit the pledging of assets and the drawing-down of committed bank lines, regardless of market conditions. Securities firms may also use extended

\(^3\) PDs are exposed to marked-to-market (MTM) losses (on account of drop in prices of held securities) if the systemic interest rates undergo an upward shift.
debt tenure to lower funding risks. In the Indian scenario, however, very few securities firms have raised long-term debt.

CRISIL reviews a company’s contingency liquidity plans, the feasibility of such plans, the liquidity of assets funded, and access to repo/call or securities lending markets. For PDs, especially, CRISIL factors in their strong liquidity (in terms of the reasonably liquid nature of government securities and access to RBI refinance and call and repo markets).

**Management quality**

CRISIL considers management quality an important credit consideration for securities firms. Even at large firms, business units may depend on a few individuals. As a result, the ability to attract, develop and retain quality professionals can provide an important competitive edge.

CRISIL evaluates the experience and stability of the management team, its track record in responding to market changes and the company’s risk culture in terms of the management’s risk appetite and risk mitigation strategies. The size of trading operations vis-à-vis the company’s capital and income is a significant factor in assessing the management’s risk appetite.

**Conclusion**

CRISIL rates securities entities based on their business, financial and management risks. RMS across various business lines (such as broking, lending and arbitrage trading) form an integral part of the business risk assessment. This is complemented by the ability to tap diversified sources of funds and by market position. The financial risk is evaluated on the basis of capitalisation, earnings and liquidity. While traditional gearing metrics are also used, networth coverage assumes prominence. Ability to tide over cycles and a lean cost structure are beneficial as far as earnings are concerned. A securities firm should have ample liquidity to meet short-term needs. Finally, a strong management profile is critical in such a regulated and confidence-sensitive industry.
About CRISIL Limited

CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better.

It is India’s foremost provider of ratings, data, research, analytics and solutions with a strong track record of growth, culture of innovation, and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers through businesses that operate from India, the US, the UK, Argentina, Poland, China, Hong Kong and Singapore.

It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

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