ncr

National Credit Ratings Ltd.

Brokerage House Rating Methodology

Brokerage Company mainly acts as an intermediary that connects buyer and seller to facilitate transaction of stocks/shares. Brokerage companies typically receive revenue by means of commission (either flat rate or a percentage of the amount of the transaction) after successful completion of transaction.

Credit rating methodology of NCRL for Brokerage Houses provides an analytical framework that focuses on the key operational, business, Management, financial and other risk factors associated with this particular business. These factors are most critical in assessing the overall performance, competitive positioning and its ability to withstand adverse operating environment & service its debt obligations.

The current credit rating methodology is not conclusive list of the factors reflected in rating outcome as the factors will be continuously modified to capture the changes within the industry, regulations etc, but it should enable a brokerage company to benchmark itself on these key considerations used by NCR while assigning a credit rating.

Methodology of NCRL comprises an analysis of the following factors;

Factors	Sub-Factors
Operating Environment	Market Dynamics Competitive Dynamics
Business Infrastructure	Information Technology Management Information System Back Office Operations
Management & Corporate Governance	Promoters quality Stability and experience of top management Governance
Regulatory and supervisory framework	Quality of Financial Reporting Quality of Compliance
Risk Management framework	Management of Credit Risk Management of Market Risk Management of Operational risk
Financial profile	Earning, stability and Profitability Asset Quality Capital Adequacy Leverage

1.0 Operating Environment

Brokerage houses business performance is highly linked to the domestic capital market which is affected by various macro and micro economic 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 firm and NCRL assesses the same on the following parameters:-

1.1 Market Dynamics

This includes changes in operating environment of capital market related operations like:

- Overall Economic situations, various industry profile, Microeconomic and Macroeconomic indicators, government initiatives etc.
- Structural changes imposed by regulatory authorities
- Level of turnover, market participants, volatility of stock prices etc

1.2 Competitive Dynamics

Competitive operating environment has a considerable impact on Brokerage firm'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, improvement client base for maintaining its margins. The competitive dynamics of business is analysed on the following parameters:

- Ability to overcome the competition for growing its business volumes and ability to attract & retain key employees in a highly competitive situation.
- Assess particular company's competitive dynamics, NCR look into its each line of business or services provided
- Extent of diversification of business revenues, that is, types of services, e.g. retail equity broking, institutional clients, advising services relating to IPO, clearing services, DP service, margin funding arrangements
- Proportion of revenues and profits from various activities and their stability.
- Extent of customer diversification (customer types would include proprietary, retail, high net worth individuals, and institutional), and stability of income from various client sets.
- Spread of business among various institutional clients. High dependence on few clients would increase business risks.

2.0 Business Infrastructure

2.1 Information Technology

- Adequacy of infrastructure as required to comply with the requirements of regulations
- Adequacy of connectivity with exchange house
- Communication network and there availability with branches
- Business continuity/ disaster recovery plans
- Ability to scale up its IT system in line with the business growth

2.2 Management Information Technology and Back office operations/support

- A robust Management Information System (MIS) plays a crucial role for a brokerage house in monitoring the operational efficiency. The MIS helps monitoring of dealer limits, client limits besides ensuring smooth running of the normal business operations. NCR's assessment framework involves evaluation of the quality and timeliness of the reports generated through the MIS and its relevance for the broker in improving upon its business performance.

- The strength of the back office operations play an important role for ensuring efficient services to the clients 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 customer services. NCR's evaluation of entities back office operations comprises of assessment of the processes, quality of the data recorded, storage facility, and the level of automation.

3.0 Management and Corporate governance

3.1 Promoters strength

- Promoter's track record in terms of growth of the business, risk appetite, transparency in running the operations of the business, commitment and financial support to the business in distress situation are considered.
- In NCR's view, companies operating as subsidiaries of strong institutions are expected to derive higher comfort as compared with companies backed by individual promoters.

3.2 Stability and experience of the top management

- Stability and experience of top management in capital market business operations
- Track record to successfully respond to changes industry dynamics'
- Ability to attract and retain talent
- Frequency and quality of training
- Well laid succession plan for the top management

3.3 Governance

- NCR's analysis of corporate governance practices involves review of the delegation of authorities and responsibilities among the Board/owner and the management and the rules and procedures laid down and followed for making decisions on corporate affairs
- Experience of the board of directors
- Participation in the board meeting

4.0 Regulatory and Supervision framework

4.1 Accounting quality

- Adherence to proper accounting practices
- Quality and transparency in disclosures

4.2 Quality of Compliance

The legal compliance is very important for a brokerage house because of the stringent enforcement of rules by the regulators. NCR assessment of the quality of compliance involves

- Examination of the compliance record of the brokerage house along with the internal control measures adopted for ensuring adequate legal and regulatory compliance.
- Attitude of management towards legal compliance and the internal systems in place for assuring compliance parameters to assess the probability that broker's service continuity will not be affected by the action of the regulators.
- Maintaining the regulations provided by the competent authority from time to time

4.0 Risk Management

NCR evaluates systems, policies and practices specific to the business lines as well as those pertaining to general operations of the securities company. Through management discussions, NCR ascertains the risk policies and how well these policies are adhered to. Securities firms face numerous risks, including market, credit, operational, legal, regulatory, and business risks. While some risks can be quantified and measured. It is of prime importance for the brokerage houses to maintain stringent risk management framework and monitoring system.

NCR reviews the risk management guidelines, developed and used by the company and the extent of deviation from set guidelines. NCR evaluates the credit appraisal system and procedures for approving new clients and the initial deposit requirement, setting up of counter-party limits, margin call policy, efficiency of the follow ups in case of margin shortfall, procedures for approving under-writing deals or merchant banking investments, and concentration of business with any particular client.

NCR evaluates the market risk on the client in terms of setting up and monitoring the client-wise exposure limits, quality of the collateral against margin loan. A brokerage house with small volume of own portfolio as compared to the overall asset size, risk based trading policy are indicators of sound market risk management.

Strong internal controls to mitigate operational risks which includes the adequacy of the internal control and information systems, 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, errors in trading and investment, fraud and embezzlement should also looked into.

5. 0 Financial Profile

The financial strength of brokerage houses is assessed to determine the sustainability of its operations. The diversity of revenue streams, dependence on a few big clients is assessed. The various avenues of revenues and their trends are assessed along with parameters such as market share, and client profiles. The profitability, asset quality and leverage indicators are evaluated.

While evaluating profitability parameters NCR considers the sustainability of trading fees, and commission income, particularly in volatile markets. To some extent, a firm's track record of earning through prior economic downturns. However, the strength, diversity, and level of capital supporting it are also important considerations. NCRL considers ratios by trend and, usually, relative to industry peers.

National Credit Ratings Ltd.

Zaman Tower (8th Floor).
37/2, Purana Paltan (Box Culvert Road),
Dhaka-1000
Tel: +88-02-47120156-58
E-mail: kishor@ncrbd.com
Website: www.ncrbd.com