



RATINGS

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## RATING METHODOLOGY: STOCKBROKING COMPANIES

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### SUMMARY

*This paper provides a specific overview on key risk areas peculiar to stockbroking companies. This paper should be read in conjunction with the methodology paper on corporate credit ratings, for a complete rating approach to stockbroking companies.*

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The rating process for stockbroking companies or “SBCs” involves the analysis of both quantitative and qualitative factors, to determine the level of risk in an SBC’s ability to meet its financial obligations in a timely manner. This paper on RAM’s approach to the rating of SBCs should be read in conjunction with our methodology paper on corporate credit ratings. Methods to assess common key risk areas such as growth potential, vulnerability to industry factors, barriers to entry/exit, threats of substitutes, level of competition, basis of competition, market position, customer analysis and others can be found in the paper on corporate credit ratings (including the relevant rating scale). This paper only highlights the specific risks that are peculiar to SBCs.

## **S** TOCKBROKING BUSINESS

The fortunes of SBCs are directly linked to the performance of the stock market. SBCs provide a service for investors to trade in shares of companies listed on the local bourse. A volume game, SBCs' incomes principally stem from commissions earned from their clients' transactions. The more volatile and active the stock market, the more opportunities for SBCs to generate revenue. Correspondingly, however, credit risk exposure also increases as each trading transaction only has a short credit period. In Malaysia, payment must be settled within 3 business days after the completion of the transaction, i.e. T+3. Increasingly, SBCs have been trading on the stock market under their own treasury accounts. This particular activity increases the SBC's exposure to market risk.

To cover SBCs' exposures to their clients, the stockbroking industry in Malaysia introduced the concept of remisiers. Remisiers are free agents responsible for the credit exposures of their respective clients, which they deal with personally. Not being salaried staff, remisiers are compensated with a cut of the commissions earned from the transactions of their respective clients. In return, as a buffer against potential losses, each remisier has to deposit a certain amount of money with the SBC, from which losses can be set off. Generally, the amount of credit exposure each remisier can have will be a multiple of his/her deposit.

Besides remisiers, there is also another class of traders that are employees of SBCs, known as dealers' representatives (to be termed "dealers" for the purpose of this paper). Dealers usually trade for high-net-worth individuals or institutional clients. Although they are paid salaries by SBCs, dealers also get compensated through a cut of the commission made from their clients' trading activities.

Apart from the traditional service of being an agent for buyers and sellers of shares, SBCs have also introduced a host of other products as incentives for their customers to trade with them; the main product is margin financing. Other products offered are usually complementary to the main service of share trading, such as an equities research unit, Internet and telephony trading facilities, as well as underwriting. Margin financing is a credit facility provided by an SBC to its clients, with the sole purpose of trading in shares. As SBCs are not deposit-taking institutions, this particular service is one of the primary reasons why they usually fund this activity with borrowing from banks or by issuance of bonds.

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## PERATING ENVIRONMENT

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The first step in the rating process is the assessment of the SBC’s operating environment, which focuses first on the stockbroking industry and the regulatory framework, before any SBC-specific analysis. An understanding of this environment involves the analysis of the economic climate, Government policies, regulatory guidelines and the level of competition among the various SBCs. Other factors that are examined include the SBC’s market position and financial flexibility.

### Industry Characteristics and Trends

SBCs operate in an industry characterised by high levels of volatility, risk and uncertainty. As such, the financial performance and quality of debtors of SBCs are highly dependent on these factors. Although this industry has high barriers to entry in terms of having to obtain licences, competition among the players remains intense in light of the limited room for product differentiation. Moreover, it is also a highly regulated industry.

Historically, the dynamism of the securities industry, together with fixed financial obligations and volatile revenues, have placed SBCs in a high risk environment which, without strong controls, could expose them to serious operating and asset quality concerns.

High turnover of dealers and remisiers, particularly during a bull run, is the norm for the industry. This phenomenon adds further volatility to an SBC’s financial performance. Additionally, many SBCs have expanded their businesses through the provision of margin trading facilities to supplement their brokerage income.

The working capital requirements of SBCs are a function of trading volumes. In a bear market, such requirements are significantly reduced. However, for firms involved in margin financing, funding needs could remain high. If borrowings are the main source of funding, SBCs will be exposed to interest rate and liquidity risks.

The stockbroking industry remains unpredictable and volatile, with a tendency to over-react. It would not be remiss to say that such characteristics will always remain. Therefore, prudent balance sheet management and a sound credit culture are the key ingredients for success. With such qualities, SBCs should be able to weather crises much better.

## S BC-SPECIFIC ANALYSIS

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In rating an SBC, the foremost consideration is to assess the likelihood that it may face difficulties in repaying its financial obligations in a timely manner. The analytical focus should therefore be on the SBC's risk management framework, capital adequacy, financial performance, funding and liquidity, and off-balance sheet activities.

## R ISK MANAGEMENT FRAMEWORK

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### Credit Control Policies

A well-managed SBC must have documented and proven credit control policies. It should have terms of reference, responsibilities, limits, action triggers and remedial procedures, among others. Nevertheless, what is more important is that the entire process must be proven. Setting limits and triggers without the benefit of empirical evidence may create a control process that may not adequately highlight and measure the risks confronting the SBC. As such, a track record is required before an analyst can carry out a fair assessment of the effectiveness of the control process.

Key areas that the control process should cover are as follows:

- Single customer limit - Concentration risk by customers should be minimised. Typically, 25% (or thereabouts) of the shareholders' funds would be the exposure limit for a single customer. Generally, customers generating more than 5% of an SBC's income during a financial year are construed as major clients. These clients and their trading track records with the SBC should be assessed.
- Client profile - retail versus institutional clients. An SBC with predominantly retail clients will have a slightly different risk profile compared to one with mainly institutional clients. For example, retail customers' trading volumes are, on average, lower than those of institutional clients. Therefore, for the same volume of business, there is more customer diversification in retail clients compared to their institutional counterparts. On the other hand, income to client ratio is better with institutional clients (in spite of discounts given on commissions due to bulk purchases) than with retail customers. Normally, a 50:50 distribution between retail and institutional clients is considered ideal.
- Dealer and remisier profile - trading limits and reliance on a small number of dealers and remisiers. Analysis should focus on the trading limits imposed on the dealers and remisiers,

and their respective trading performances. An important factor to consider is how the trading limit is calculated (e.g. marked-to-market real-time or marked-to-market at the end of the day). A higher-than-normal level given to a select few should be investigated.

- Margin financing profile. What are the criteria that a client should have before a margin facility is provided? Does the SBC have a pre-determined internal policy to force-sell shares when security coverage falls below an acceptable level?
- Proprietary trading. The SBC must have well-defined objectives for its proprietary trading operations. Analysis of the track record of such trading should be undertaken. More importantly, it is crucial to understand internal controls as these tend to be the root of SBCs' difficulties.

## C APITAL ADEQUACY

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From a credit rater's perspective, analysis of an SBC's capital adequacy focuses on its ability to absorb future credit losses. If a significant portion of its net exposures were to default, to what extent would its shareholders' funds be impaired? In this instance, an analysis of the net exposure vis-à-vis shareholders' funds - tracked on a daily basis (if possible) - would provide a good indication of the level of risk faced by the SBC. The variance of the ratio would also indicate the volatility of these risks.

Analysis of gearing ratios is also important. However, the method of analysis is no different from that in the generic methodology paper on corporate credit ratings.

## F INANCIAL PERFORMANCE

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The movements of the stock market largely govern the profitability of an SBC. An examination of the trend of an SBC's brokerage income tends to show some sort of correlation to the performance of the stock market. Nevertheless, this is not the only form of income for SBCs.

Generally, an SBC's income can be categorised into 3 main sectors: brokerage income, margin trading income, and other operating income (that can emanate from investment income and fees generated from non-trading products). A good mix of these 3 income categories would be ideal.

Due to the volatility of the stock market, analyses of pre-tax profits and cost-to-income ratios do not necessarily provide a good indication of the financial health of an SBC. A better indicator of financial health can be found in the SBC's profit track record. A loss in a particular year may not mean that the SBC is facing fundamental problems. More often than not, the loss is only a reflection of the poor market conditions. However, what is more important is the quantum of loss compared to its peers and whether this position is expected to persist.

## **F**UNDING AND LIQUIDITY

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Due to the inherent volatility of the stock market, liquidity ratios usually vary according to market conditions. In an active market, gearing levels tend to soar. On the other hand, SBCs (i.e. those without margin financing business) would have virtually no borrowings during lull periods. In most cases, borrowings tend to be short-term and have a revolving nature.

## **O**FF-BALANCE SHEET EXPOSURE

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Off-balance sheet exposures are analysed to determine the level of credit and market risks. Of particular importance are things such as underwriting, guarantees and, to a lesser extent, derivatives. Therefore, internal controls and risk management are of utmost importance. Our analysis attempts to understand the controls that are in place to mitigate the inherent risks of such activities.

## **M**ANAGEMENT ASSESSMENT

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A competent management team has an important role in ensuring the stability and development of an SBC. Risk appetite is also another key area on which we place much emphasis as this will dictate the risk tolerance level of the SBC. In addition, we will also look into the long-term strategies and business direction of the company, as this will ultimately affect its market position and financial performance.

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No statement in this methodology is to be construed as a recommendation to buy, sell or hold securities, or as investment advice, as it does not comment on the security's market price or suitability for any particular investor.

While every effort has been made to incorporate the salient points of RAM Ratings' experience in relation to the methodology, we note that the information contained could be updated and altered depending on changes in our internal views, market conditions, accounting practices and regulations. The methodology is also based on factors relevant to Malaysia and may require adaptation to local conditions.

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