Title : Issues plaguing the Equity Broking Business model in India – A suggested 'FIX'

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Abstract : Service Industry is an important component of GDP in India. Financial Services industry, that includes Equity Broking business, is a potential employment generator for our country. In the last one year the Stock market indices viz. BSE Sensex and NIFTY have touched record highs. This should have augured well for Equity Broking Business. However the figures provided by SEBI show that Brokers are shutting shops. What went wrong? This paper analyses the Fundamental issues related to 'Brokerage' focused revenue model that motivates churning of portfolio and leads to losses for clients and ultimately hits the Broking business itself. To fix this, an 'Advisory fee' based model is suggested.

(Full Paper)

The BSE Sensex touched an all time high recently in March 2015. From a level of 20000 odd in 2013 to high of 30000 plus (intraday) on 4th March, 2015. This should have called for a celebration for the Equity Brokers (Financial Intermediaries through whom shares can be bought or sold for a commission called brokerage). Buoyancy should have returned to the broking business, as is the general expectation when the stock market rises. Has this been the case? A look at the figures provided by SEBI and quoted from an article in Business Line (The Hindu Business Line, 2013) paints a picture that is far from being sanguine for the Equity Broking Industry

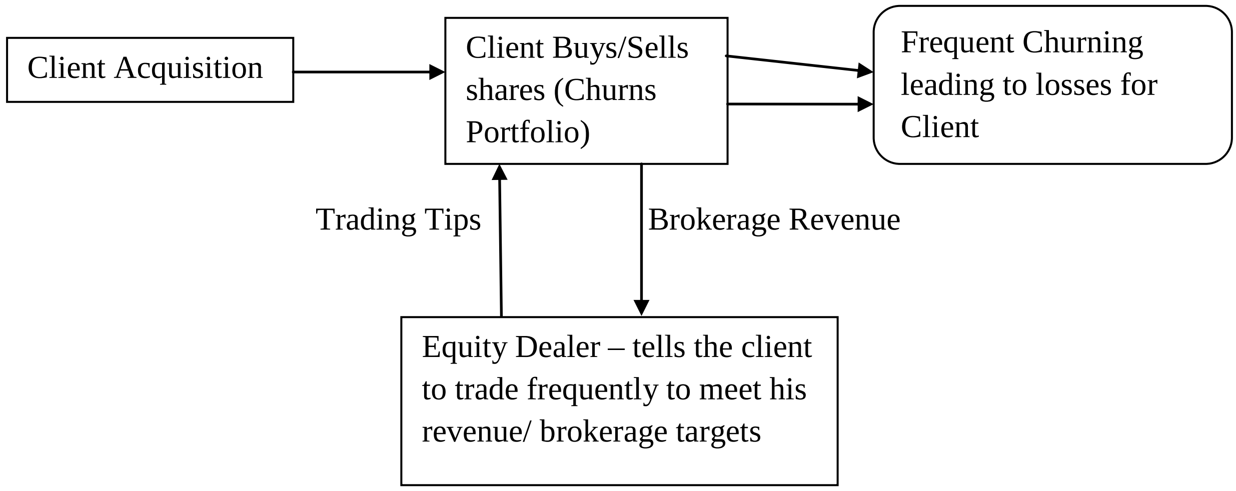
(Figure -1) (The Hindu Business Line, 2013)

'The data till Sep-2014 shows that 522 brokerages and 12,855 sub brokers shut shop compared to 2013'. This is estimated to have resulted in 40000 job losses. The trend of stock market (Sensex) rising and brokers closing down has continued even in 2015. What is going wrong? Based on my experience in the industry I can formulate the following reasons/questions broadly:

1. Is the market large enough for the numerous extant players to sustain profitability?
2. Are the retail investors completely shying away from Equity Broking investments and/or taking on the Mutual fund route to investments?
3. Is the current Business/Revenue model of Equity Broking flawed?

The above list is not exhaustive and there could be other reasons. However, if I attempt to answer them, I am not sure of about the first question regarding the size of market being sufficient. For the second question one can look at the Assets under Management (AUM) that seem to be rising for Equity Mutual funds and get a feeling that the rise does indicate some preference for Equity Mutual Funds. However it cannot be said conclusively if that was responsible for such poor show by Equity Brokers.

A more fundamental question is whether the Business/Revenue model of the Equity Broking business is flawed? To answer this let me put the model in perspective (of course based on my experience and industry knowledge).



(Figure -2 ; Current model of Equity Broking Business, Created by the Author)

The model which is prevalent in the broking industry is that the client acquisition team is responsible for enrolling new clients. The clients are then taken care by Equity Dealers. The Dealers are given revenue targets in form of the brokerage to be generated. The brokerage would get generated when the client either buys or sells shares. Therefore the dealers follow a simple (but dangerous) rule of, 'Higher the churning (Buying or selling in the Portfolio), Higher the revenue'. More often than not, the targets set and incentives offered, for meeting the targets motivate the equity dealers to take this undesirable route. The fallout of this churning invariably has been the losses for the retail client over a period of time. The client's money, meant for investment, effectively gets consumed in meeting losses due to churning and the brokerage charges payable. It may be pertinent to note here that a major chunk of money is usurped in meeting the losses due to trading and much less is received by the dealer as brokerage. In spite of knowing this fact, little effort has been made by the industry to review the current model and look at a better one. To sustain business there is an ever increasing need for new clients with fresh money. It is obvious that there is limit to number of clients that can be acquired in a short span of time. And even if new clients are acquired they would meet the same fate as their predecessors. In a nutshell, following are the problems with the current Business/Revenue model:

a) The rate, at which new clients are required, to replace the old loss making clients, is too high to be realized on a sustained basis.

b) Clients who taste the bad experience of making loss (due to churning), do not return to the stock market and potentially de-motivate other aspirants planning to explore stock market as an investment opportunity.

c) This is a business model that strongly makes the clients trade/invest in stock market for very short term, contrary to the advised fundamental of long term horizon required and desired for investment in shares.

d) The equity dealers are also not immune to the impact of losing the client base. Eventually the client base dwindles out and business can no longer afford to employ the Equity dealers. Several of these young employees who once used to draw fat salary cheques and bonuses are rendered unemployed.

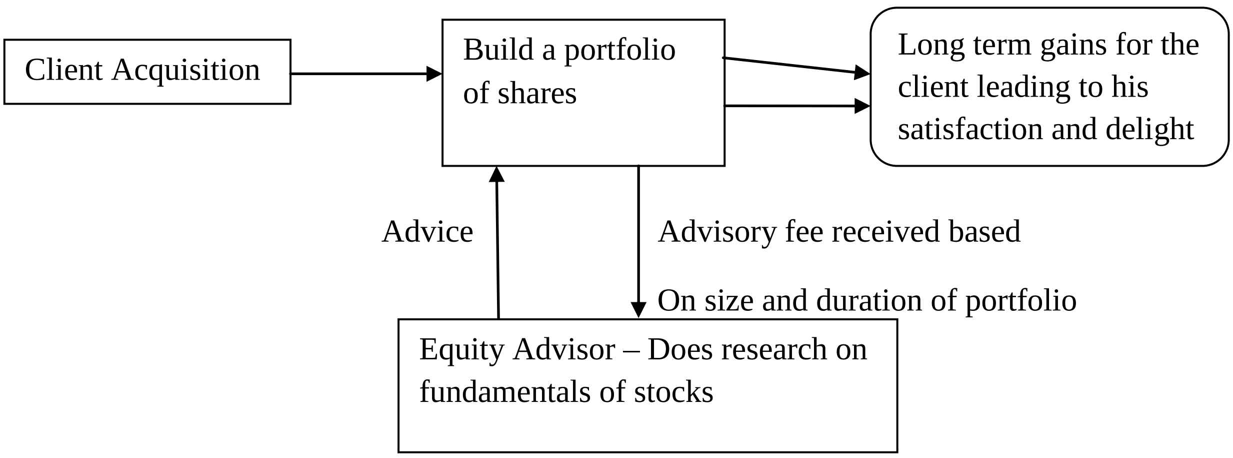
The conclusions that can be drawn about the current business model are:

1. **It is a revenue model that does not take care of the interest of the clients (in fact works against their interests)**
2. **Defeats the very purpose of long term horizon required for equity investments**

So, how can the model, devoid of these basic things, be **SUSTAINABLE**????

This motivated me to thing about an alternative proposition for the Equity Broking. The model that is proposed may sound unusual but than the problems are also not usual either.

Instead of making the Equity (Intermediation) Business brokerage driven, it can be made 'Advisory Fee' driven. This means that the focus of the business should be to advise clients to build a portfolio of shares, based on fundamental research, and charge a fee for this service. Rather than charging brokerage on buying and selling shares. The fees would depend on the value of the portfolio of shares and time (duration) for which the shares are held. Schematically the model can be represented as:



(Figure -3 ; Suggested model of Equity Broking Business, Created by the Author)

In this fee based model there is no incentive for churning the portfolio to the detriment of client. In fact there is an incentive for getting larger investments to stay for a longer period as the revenue is proportional to size as well duration of the investments. This will have the following advantages:

1) Churning that is detrimental to client's interest is avoided

2) Investment in equity is meant for long term horizon and this model conforms to this practice

3) The equity advisor will be rewarded for client's gains. A rise in value of the portfolio will increase the income for the equity advisor too. This aligns the interest of advisor to that of the client. Obviously , 'NO CONFLICT OF INTEREST'

A major point in this model is that a portfolio large enough is required to be build for sustaining the salary cost of equity advisor. For illustration, if the salary for an advisor is Rs. 3 lakhs per annum and the advisory fee to be charged is 2%. A portfolio with a value of Rs. 1.5 crores will have to be built to sustain the cost of the advisor. This may take a few months or a year. But once, the portfolio is built and grown it can be a source of sustained earnings for the advisor and his employer. A delighted and satisfied client is the best marketing tool, and therefore can help the advisor to grow his client base by giving referrals. This can considerably reduce the forced attrition of Equity advisors and build long term business and relationships with clients. Some in the financial services industry may argue that this is similar to mutual fund investments, than why at all to have this 'add-on'. It should be noted that in spite several years of existence of Mutual fund industry, investors continue to hold investment in direct equity. It is not one against the other, there is space for both. Investors tend to have investments in both the Mutual funds as well as direct equity.

A major benefit of this kind of model could be that, several management graduates who aspire to take up equity research and advisory route (outside of the Mutual fund industry) could find a new business opportunity. These intellectuals can put their research and business valuation skills to use, for the betterment of clients planning to invest in shares. It can open an avenue for self employment for thousands of management graduates who wish to make their mark in the Financial Services industry.

The implementation of this 'Equity Advisory Model' could call for cumbersome regulatory changes. But I guess, the model is worth the effort!!!

Works Cited

1) The Hindu Business Line. (2013, November 8). *40,000 jobs lost as brokerages shut shop despite market surge.* Retrieved 2015, from http://www.thehindubusinessline.com: http://www.thehindubusinessline.com/markets/40000-jobs-lost-as-brokerages-shut-shop-despite-market-surge/article5330493.ece