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India Ratings Affirms Indian Clearing Corporation at 'IND AAA'/Stable

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By Jinay Gala

India Ratings and Research (Ind-Ra) has affirmed the Indian Clearing Corporation Limited's (ICCL) Long-Term Issuer Rating at 'IND AAA' with a Stable Outlook. The rating, which indicates ICCL's credit risk profile on Ind-Ra's credit rating scale, is for the benefit of clearing members that are ICCL's counterparties.

The rating reflects ICCL's strong track record (earlier as the internal clearinghouse of BSE Limited) in managing risks in post-trade clearing and settlement and collateral management. Ind-Ra also considers the collateral-backed nature of ICCL's business model and BSE group's governance framework. A proactive regulatory regime along with BSE's high capitalisation relative to ICCL's settlement volumes also provides comfort.

KEY RATING DRIVERS

Strong Linkages with BSE: ICCL provides clearing and settlement services for trades executed at BSE in its role as the clearing corporation of BSE. ICCL is also a systematically important entity for seamless functioning of BSE exchange operations, as also being its 100% subsidiary. Any operational failure would have strong implication on the reputation of BSE as self-regulated exchange as ICCL bears the counterparty risks of members and guarantees financial settlement. Also, transaction volumes at BSE have a direct impact the profitability of ICCL. Thus, maintaining adequate risk cover in terms of Core SGF where the contribution from BSE based on the Minimum Required Corpus remains a key monitorable and is systematically important.

Strong Liquidity Buffers: Securities and Exchange Board of India's (SEBI) mandates maintaining of Core-Settlement Guarantee Fund (C-SGF) for clearing corporations. ICCL had INR2.46 billion in C-SGF applicable for the month of March 2017, which should be readily and unconditionally available to meet settlement obligations. SEBI also prescribes daily stress testing (across all segments effective 1 December 2014) aligned with Principles for financial market infrastructures (PFMI) prescribed by the committee on Payments and Market Infrastructures and International Organisation of Securities Commissions(CPMI-IOSCO), which bolsters the safety net. SEBI prescribes a monthly review computation of C-SGF requirements and daily review of C-SGF. ICCL also has INR4.02 billion in counterparty default insurance (which comes above the C-SGF in the default waterfall) and robust lines of credit from commercial banks to the tune of INR8.0 billion, which adds to liquidity risk cushion.

Strong Operational Risk Monitoring: ICCL's operational risks remain high. Direct risks could emanate from possible systems failure, leading to inadequate margins, while indirect risks could come from operational failure at BSE where it has strong reputational linkages. ICCL manages operational risk through its disaster management systems and has reported a zero loss record due to operational failures so far. Furthermore, its operations are subject to regular audit and inspections by SEBI. ICCL maintains a far disaster recovery site in a different seismic zone, which is reviewed and tested periodically to ensure seamless clearing and settlement. ICCL also maintains SEBI mandated INR1.00 billion as part of its recovery and resolution process for covering operational cost for one year, legal cost, regulatory cost, and other liabilities.

Adequate Risk Management Practice: ICCL manages credit risk by imposing the regulator-prescribed value at risk (VaR) and extreme loss margins on clearing members and their clients for each open position and monitors collateral adequacy on a real time basis. Ind-Ra's tests (increasing VaR confidence levels to 99.99% and measuring margin adequacy for the worst one-day decline in the last 10 years for 30 actively traded stocks) on cash segment practices indicate that prescribed margins continue to cover most extreme stock scenarios in volatile periods and large shortfalls were largely on account of idiosyncratic factors. However, the stress tests for two-day VaR indicate that the current margins are insufficient for 10 instances out of 30.

That being said, the circuit filters allow markets to process new information during sudden market-wide shocks.The real time risk management system generates various alerts at different collateral utilisation levels (70%, 80% and 90%), puts the member in risk reduction mode at 90% and disables the trading terminal of a member when the collateral utilisation exceeds 100%. The risk reduction mode helps to mitigate risk during volatile times.

Strong Regulatory Oversight: ICCL's risk profile benefits from SEBI's strong regulatory oversight over the clearing corporation's risk management, governance practices and capital requirements. This entails having an independent board, defined guidelines of executive compensation, regulatory screening of key executives and the prevention of trading or clearing members from being on the board. Ind-Ra draws comfort from SEBI's highest ratings (level 4: June 2016) in the Third Update to the Level 1 Assessment Report of the Implementation Monitoring of PFMI by CPMI-IOSCO in various countries and the Qualified Central Counterparty status granted to ICCL by SEBI for its compliance with the PFMIs issued by CPMI-IOSCO.

Strong Capital Levels: Ind-Ra views ICCL's current equity position of INR5.24 billion at end-FY17 as adequate for the current business volumes. Risk coverage ratio (net worth to value of shares delivered) was 33.87% in the equity cash segment. The agency opines ICCL may also receive equity or liquidity support from BSE (FY17 equity: INR24.29 billion) in case of a crisis, due to the high reputational risk involved.

ICCL has revised its terms with BSE and now it neither receives the clearing and settlement income nor pays any investment income to BSE. A focus to increase while also maintaining the current market share in the equity cash and derivatives segment is pivotal for profitability and coverage of the fixed costs borne by ICCL, since investment income from the collateral deposited by members with ICCL is a crucial component of revenue.

RATING SENSITIVITIES

A decline in BSE's competitiveness, leading to a sustained erosion of ICCL's operating profitability, could lead to a revision in the rating Outlook to Negative. The rating could face multiple-notch downgrades if ICCL's capitalisation is affected due to defaults by clearing members or if capital levels appear inadequate to protect any enhanced legal or operational risk arising out of evolving business models.

COMPANY PROFILE

ICCL was incorporated in 2007 as a wholly owned subsidiary of BSE and is regulated by SEBI as an FMI entity and the Reserve Bank of India for select products. It carries out the functions of clearing, settlement, collateral management and risk management for various segments of BSE. ICCL acts as a central counterparty through the process of novation; it becomes a buyer for all sellers and seller for all buyers. ICCL settles trades reported on the debt and mutual fund segments of BSE and clears and settles trades executed on all the segments of BSE including equity cash, BSE SME, offer for sale, securities lending & borrowing, equity derivatives, debt segment, sovereign gold bonds, interest rate futures and the currency derivatives segment.

RATING HISTORY

Instrument Type	Current Rating/Outlook	Historical Rating/Outlook

	Rating Type	Outstanding Limits (billion)	Rating/Outlook	28 April 2016	26 November 2013
Issuer rating	Long-term	-	IND AAA/Stable	IND AAA/Stable	IND AAA/Stable

COMPLEXITY LEVEL OF INSTRUMENTS

For details on complexity levels of the instruments, please visit https://www.indiaratings.co.in/complexity-indicators.

SOLICITATION DISCLOSURES

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India Ratings and Research (Ind-Ra) is India's most respected credit rating agency committed to providing India's credit markets accurate, timely and prospective credit opinions. Built on a foundation of independent thinking, rigorous analytics, and an open and balanced approach towards credit research, Ind-Ra has grown rapidly during the past decade, gaining significant market presence in India's fixed income market.

Ind-Ra currently maintains coverage of corporate issuers, financial institutions (including banks and insurance companies), finance and leasing companies, managed funds, urban local bodies, structured finance and project finance companies.

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For more information, visit www.indiaratings.co.in.

DISCLAIMER

Applicable Criteria

Non-Bank Finance Companies Criteria

Rating FI Subsidiaries and Holding Companies

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