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Overview of the Settlement Mechanism in the Indian Securities Market

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Abstract

Trading, clearing, and settlement are three key processes in the stock exchanges. This paper presents an overview of the settlement mechanism of the stock exchanges. The settlement system ensures that the sale proceeds are credited into the seller's account and securities transferred to the investor or buyer's account by virtue of their trading in the stock exchanges with lesser settlement risks because settlement involves risks that are associated with the settlement cycle. The settlement cycle is an important factor influencing the liquidity and turnover of the market. Earlier, the settlements were made on the share certificates in paper form and with a longer settlement cycle. Advancement of trading technology simplifies the settlement system on account of trading transactions in the electronic and settlement also through clearing corporations. The specialty of the settlement mechanism is that the settlement of trade is made irrespective of the default by any member and subsequently, the exchange follows up with the defaulting member for recovery of dues to the exchange. The efficiency of the settlement mechanism ensures liquidity and safety with lesser settlement risk besides improving the efficiency of the stock exchanges/market.

Keywords: Market, rolling, settlement, stock, trading

INTRODUCTION

Settlement is a mechanism that simplifies the trading process in the market, namely, sellers to collect payments for the sale of securities, and buyers to take delivery of securities purchased. It is an institutional arrangement that operates through clearing agents/corporations and facilitates the netting of the transactions, the confirmation, clearance, settlement, and safekeeping of securities traded. The clearing process commences immediately after the confirmation of trade to effect payment on the settlement date. The duration of the settlement influences the liquidity and safety of the securities market. The longer the settlement cycle, the availability of resources to trade will be lesser and at the same time, the shorter settlement cycle increases the liquidity of the traders in the market.

PARTICIPANTS INVOLVED IN THE TRADE SETTLEMENT

Clearing corporations, clearing members, clearing banks, and professional clearing members are the participants/institutions involved in the process of the settlement of trades executed at the stock exchanges.

Clearing Corporation

Clearing corporation/settlement guarantees funds and ensures that there is no delay in settlement due to the failure of any member to honor their commitment to the exchange on time [1].

The central counterparty reduces the risk of settlement and transaction costs. The recommendations of the IOSCO CPSS (International Organization of Securities Commissions, Committee

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on Payment and Settlement Systems) Task Force also encourage settlement guaranteed by the clearing corporation/house of the stock exchanges [2].

Securities and Exchange Board of India (SEBI) advised all the stock exchanges to set up a clearing house/clearing corporation or settlement guarantee fund, in order to ensure the timely completion of the settlement.

Indian Clearing Corporation Limited (ICCL) for the Bombay Stock Exchange and NSE Clearing Limited, formerly known as The National Securities Clearing Corporation Limited (NSCCL), for National Stock Exchange (NSE), engaged in the clearing and settlement of trades and risk management besides covering all settlement costs of default of members, are playing a vital role in the clearing and settlement process in the securities market.

Clearing Members

The contribution of clearing members in the process of clearing and settlement is significant. Stock exchanges transfer the trading transactions of trading members through ICCL/NSECL to clearing members of BSE/NSE.

Clearing Banks

It is the responsibility of clearing banks to carry out the settlement of funds through clearing accounts of the clearing members opened with them through pay-in and payout.

Professional Clearing Members

Banks, custodians, and other entities form part of professional clearing members. The NSECL's special category of members includes individuals or professionals, who can clear and settle trades for their clients only.

SETTLEMENT RISKS

Security trading provides opportunities for investors to make a profit and at the same time, it has some risks intrinsic to the settlement system. Participants in securities settlement systems have to encounter a variety of risks of which settlement risk is a significant risk, that a party to a contract's inability to fulfill their contractual obligations to settle the other party in the securities transaction due to time delay, system failure or default, and risk associated with an unexpected cost.

Settlement risks can be broadly classified into counterparty risks and systems risks.

Counterparty Risks

During the process of settlement if one of the parties to the contract does not discharge the contractual obligations in full and on time gives rise to counterparty risks which can be classified into principal risk and replacement cost risk.

Principal Risk

The principal risk arises if one party to the contract discharges the obligation in terms of payment for the purchase of securities or delivered securities, but the other party does not receive the payment or delivered securities. These risks can be reduced by the central counterparty acting as a buyer/seller in buying/selling securities in the auction market depending upon the nature of the transaction.

Replacement Cost Risk

A party to the trade replaces the trade with the same or new terms depending on the market conditions due to the inability of the counterparty in meeting the contractual obligations is known as replacement cost risk, denoting cost associated with the original trade. Since share prices are fluctuating from time to time and the cost associated with trading also changing, the cost of replacement of a trade will be higher than the original trade in the normal course give rise to the replacement cost risk.

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Liquidity Risk

If a party fails to honor their trade obligations on time but with a delay due to operational issues gives rise to liquidity risk.

Systems Risks

Systems risks are inherent to the settlement mechanism which arises due to the failure of the system due to operational, legal, and systemic issues are accordingly classified into operational, legal, and systemic risks.

Operational Risk

Operational risk arises from any of the following: the inadequacy/failure of internal processes, human or system error, or external events pertaining to any of the above.

Legal Risk

The financial/reputational loss arises due to a lack of awareness or the uncertainty or an unexpected application of any of the provisions of the applicable laws and regulations can trigger legal risk.

Systemic Risk

It arises due to the default of any one of the parties leading to the default of other parties too, resulting in the failure in the system as a cascading effect. It develops along with the development of financial markets, regulations, and collective behavior of market participants, and it may be prompted by regulatory arbitrage.

EVOLUTION OF THE SETTLEMENT SYSTEM

The settlement mechanism underwent a long journey from paper settlement to electronic settlement and a longer settlement cycle to a shorter settlement cycle. Stock exchanges followed the fixed day/weekly settlement system for a long time and the physical share certificates reigned the Indian securities market till the introduction of the dematerialization (demat) of shares in 1996. SEBI mandated the issue of shares in dematerialized form only, gradually eliminating the physical share certificates in the market and its associated risks. However, the market faced many issues including increased counterparty risks, systemic risks, etc. on account of the long settlement cycle. To shorten the settlement cycle, the NSE, recognizing the benefits of the demat of shares and to reduce the trade cycle and settlement risks implemented a T+5 rolling settlement on July 9, 1997 [3].

SEBI, in order to solve the poor delivery, excessive liquidity, and frequent defaults problems that are associated with the settlement and considering the lower settlement risks for all large-cap companies, made compulsory rolling settlement (CRS) for the part of the BSE-200 Index, on July 2, 2001 [4]. Subsequently, to follow the worldwide best practice, SEBI brought remaining large-cap companies also under compulsory rolling settlement with effect from January 2, 2002 [5].

SEBI, considering the benefits of a shorter settlement cycle, gradually reduced the settlement period from 5 days (T+5) to 3 days (T+3) effective from April 1, 2002 [6], and further reduced from 3 days (T+3) to 2 days (T+2) in April 2003 within a year [7]. India moved to the T+2 settlement cycle in 2003. The entire world except China followed this cycle till now. SEBI planned to implement the T+1 settlement cycle during the year 2020 but considering the interest of the foreign investors and their practical problems it postponed the implementation for over two years. However, it implemented T+1 rolling settlement as an optional basis during 2021 [8]. SEBI shortened the settlement cycle further to one day (T+1) during the year 2023.

ROLLING SETTLEMENT

Stock exchanges have been following the accounting period settlement for a long time. The trades are settled on a fixed day of the week irrespective of the days of trade, which increases the settlement risk, due to longer settlement period.

Rolling settlement shortens the settlement cycle by execution of all trades [9] on successive days. The reduction of the time between the execution and settlement of securities reduces the settlement risk [10]. The specialty of the rolling settlement system is that it facilitates investors to get the sale proceeds of shares credited into their account at a faster rate with fewer settlement risks due to its shortened settlement cycle.

The trades executed on the day are netted together script-wise and settled by pay in–payout in a predefined cycle depending on the type of security.

Rolling Settlement versus Accounting Period Settlement

The rolling settlement system replaces the accounting period system. A comparison between these two systems is listed out as follows:

Practice

Rolling settlements are one of the best international practices in settlement whereas accounting period settlements are an outdated and old practice.

Trade Cycles

Trade cycles are uniform under rolling settlement whereas trades cycles differ under accounting period settlement, and it was possible to shift positions from one exchange to another.

Bid-Ask Spreads

Rolling settlement narrows bid-ask spreads and eliminates synchronization of settlement dates which reduces settlement risk whereas bid-ask spreads are widened under accounting period settlement.

Risk

The settlement risk is lower in a rolling settlement in comparison with an accounting period settlement, which follows a weekly settlement whereas trades under the rolling settlement are settled earlier than the accounting period settlement. Rolling settlement risk is considerably reduced due to trades on a particular day are separately settled from the trades executed on any other day.

Speculation

Possibilities of speculation are lesser under rolling settlement whereas under accounting period settlement exposes to more settlement risk due to the scope for both intra-settlement and intra-day speculation.

Time

Rolling settlement facilitates sellers to get their sale price and purchasers get their securities faster whereas sellers/buyers have to wait for over a week under accounting period settlement to collect the sale price/securities. Trades are settled uniformly under the rolling settlement whereas some sellers have to wait for a week and others wait for a day depending upon their time of sale to get their settlement under accounting period settlement.

Price Discovery

Better price discovery is possible under rolling settlement by eliminating excessive speculation through the segregation of cash and futures market whereas price discovery is distorted due to combining of cash and future market under accounting period settlement.

Volatility

Positions are built up during a day under rolling settlement whereas positions are built over the trading period of five days and accumulated on the last trading day yielding more pressure for closure that leads to volatility in the market.

Arbitrage

Rolling settlement eliminates the opportunity for arbitration due to daily settlement whereas accounting period settlement facilitates arbitration on account of a longer settlement period.

Manipulation

Opportunities for manipulation are less in a rolling settlement in comparison with an accounting period settlement due to a better price discovery process.

T+1 SETTLEMENT CYCLE

China became the first country and India became the second country for the successful implementation of the T+1 rolling settlement in the world. The new settlement cycle has been implemented by SEBI in a phased manner from the smallest companies to larger ones during 2021. More than 256 large-cap and top mid-cap stocks, including Nifty and Sensex stocks, were brought under the T+1 settlement besides all futures and options segment stock to be settled in a new settlement effective from January 2023.

Many advanced jurisdictions, including the United States and the United Kingdom are still following the T+2 settlement cycle. The successful implementation of the T+1 settlement cycle is a landmark in the history of the Indian securities market. It brings operational efficiency, faster remittances of funds, delivery of shares, and ease for securities market participants.

Benefits of T+1 Settlement

Rolling settlement is considered the best international practice in the settlement. The benefits of T+1 (trade plus one) settlement cycle are listed hereunder:

Reduction of Time Frame

The T+1 settlement cycle offers a lesser gap between the trade date and settlement date; saves 50% of the time than the T+2 settlement and helps the market to perform well in terms of the enhancement of a number of trades. The sellers of shares get their money and the buyers also get their shares quickly due to the reduction of settlement time.

Enhanced Liquidity

It facilitates the conversion of securities into cash or cash into securities at a faster rate. The money available for further purchase of securities within 24 hours of their sale reduces the waiting time to get funds due to lesser settlement time and increases the liquidity of sellers in the market. The market enjoys better liquidity.

Reduction of Margin

One of the issues encountered by investors in the secondary market is the availability of margins. The reduction in the settlement cycle enhances the availability of margins which in turn facilitates better trading opportunities.

Reduction of Exposure

The shorter settlement cycle correspondingly decreases the unsettled trades, which in turn reduces the unsettled exposure to clearing corporation.

Reduction of Settlement Risk

The reduction in settlement time reduces the exposure which also reduces the settlement risk.

Reduction of Systemic Risk

The major risk in the securities market is systemic risk. The more amount of trade/volume with a long settlement cycle increases the outstanding trade as well as the risk of the central counterparties.

The lesser settlement cycle reduces the systemic risk obviously a big relief to the securities market regulators, central counterparties, and also for investors.

Shortened Settlement Cycle

The longer the settlement cycle, the smaller number of trades will be lesser. Contrary to this the shorter settlement cycle enhances the chances of more trades due to better availability of liquid funds.

Less Collateral

The shorter settlement cycle improves the liquidity of a trader/investor which reduces the need for further borrowing and collateral requirements.

Enhancement of Operational Efficiency

The realization of shares sold and their credit into the bank account are faster, enhances the availability of funds from banks within 24 hours, and increases the operational efficiency on account of the faster rolling of funds. Similarly, the shares purchased are available for sale within 24 hours, thus enhancing the opportunity for further trades.

Safer Market

The shorter the settlement cycle, the shorter the time frame for a counterparty, reducing the risk of insolvency/bankruptcy that impact the settlement of a trade. It reduces the counterparty risk considerably to ensure safer trade and market.

Better Price Discovery

It offers better price discovery through the segregation of cash and futures markets and also eliminates excessive speculation.

Reduced Manipulation

The longer settlement cycles nurture the manipulative activities in the market. Since T+1 settlement facilitates a shorter settlement cycle, it reduces the opportunities for manipulation.

Elimination of Arbitration

Opportunities for arbitration are more in the longer settlement cycles whereas it is lesser in the shorter settlement cycle, especially T+1 settlement.

Better Profitability

Better liquidity with a shorter settlement cycle encourages the traders to undertake more trades, thus enhancing the opportunities for better profit and boosting the turnover of stock exchanges.

Drawbacks of T+1

Foreign investors operate from different countries spread across the globe, and they are exposed to the issues of zonal differences, information flow processes, and foreign exchange, and find it difficult to hedge their net Indian exposure in terms of dollars at the end of the day, at the inception of T+1 settlement; however, in the long run, advancement of technology especially the distributed ledger technology solves many of the issues initially encountered by them. Market infrastructure institutions (MIIs) have to increase their infrastructure for the timely transmission of files to facilitate the timely issue of pay-in and pay-out. Banks and depository participants (DPs) have to encounter an increased workload due to the availability of lesser time.

T+0 SETTLEMENT SYSTEM

Shortening the settlement cycle beyond T+1 means T+0 will be beneficial in the future. T+0 settlement system implies that the trade can be settled on the same day itself, that is, payment and delivery will be made on the same day, which is not easy and practical considering the present settlement systems and dependency on banks. However, the T+0 settlement is not far away, and it is possible on account of the advancement of blockchain technology (distributed ledger technology) and digitization of shares. If SEBI puts in its best efforts, India will be the first country to introduce the T+0 settlement. The securities markets may get amazing benefits under T+0 settlement, in terms of better liquidity, enhanced trading volumes, and lesser settlement risks.

CONCLUSION

Settlement is an important constituent of the securities market. A strong and efficient settlement mechanism enhances the safety and security of the securities market. The longer settlement cycles inherently bring systemic risk. If a set of brokers failed to settle their huge dues, its cascading effect has an adverse impact on the entire market. In the Calcutta Stock Exchange, the failure of a few brokers to settle their dues had an adverse impact on the entire market and as a consequence, the very old stock exchange ceased to exist. SEBI introduced the T+2 settlement system for the first time in the Indian securities market and it is the first country in the world to introduce the T+2 settlement. SEBI's bold initiative to implement the rolling settlement and in particular T+1 settlement is a milestone in the history of the securities market in India. SEBI may move to T+0 settlement in the future as a trendsetter of the world.

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