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An Overview of Clearing Mechanism of Stock Exchanges of India

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Abstract

The advancement of technology drastically improves the efficiency of the clearing mechanism and reduces the clearing and settlement time in the securities market. This paper analyzes the clearing mechanism by depicting its significance, functions, and process. The time of the clearing process has been drastically reduced by the regulatory regime to ensure speedy clearing and settlement of the securities transactions. It also prescribes directions to the stock exchanges to set up clearing corporations to eliminate the risks involved in the clearing and settlement. The clearing and settlement process encounters counterparty risks, which are taken care of the clearinghouse by assuring the buyers take delivery of the securities on time and sellers receive their payment on time. The reduction of clearing time and elimination of risks involved in the clearing mechanism obviously increases the efficiency of clearing as well as the market. Consequently, it also enhances the liquidity and integrity of the market.

Keywords: Clearing, counterparty, exchange, market, risks

INTRODUCTION

A clearinghouse is an indispensable intermediary in the clearing and settlement process of the stock exchanges. It acts as a link between sellers and buyers. It is engaged in clearing the securities traded, collecting, and maintaining margin monies, regulating delivery, managing the risks involved in clearing and settlement, assuring the completion of trades, and reporting trading data. It also ensures the contractual obligations of the trading parties are honored by them – the seller receiving the right payments, and the buyer receiving the right securities.

CLEARING – A CONCEPTUAL ANALYSIS

Clearing is a post-trade process that determines the obligations of the trading parties after the execution of the trade. Securities market transactions are exposed to a high risk of failure to honor the obligations of the trading parties. If a party to the transaction failed to honor their obligations or a few of the parties continuously failed to honor their obligations, it may erode the confidence of the trading parties in the market and questions the integrity of the securities market. Under these circumstances, traders are unwilling to undertake any trade in the market, which slows down the trading activities of the market and reduces the liquidity and frequency of trades. Counterparty risk is a major hurdle in securities market transactions that is mitigated by clearing corporations. It guarantees the sale and purchase transactions by ensuring the seller receives the sale proceeds and the buyer takes delivery of the securities facilitating parties to trade with each other anonymously. The effective clearing process protects the trading party from a potential loss against the counterparty risk. Clearing provides basic clearing services such as trade confirmation, transaction/position management, delivery

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management, and value-added clearing services such as novation, netting, risk management, cash, and collateral management.

SIGNIFICANCE OF CLEARINGHOUSE

Clearinghouse is significant in the securities market because it provides infrastructure and services to traders to clear and settle the trade on time. The clearing process is the vital organ of the stock exchanges, which decides the future of the stock exchanges. The efficiency and effectiveness in clearing and settlement mechanism of the stock exchange increases the turnover of the stock exchanges.

The main risk involved in trading securities is honoring the contractual obligations of the parties. Clearinghouse ensures that the contracting parties get their obligations fulfilled by eliminating the risk of failure through the collection of requisite margins from the parties.

It insulates the risk of insolvency of the parties to the contract before undergoing the clearing and settlement process through margin money.

It ensures the clearing of the securities on time as per the settlement cycle stipulated by the stock exchanges. It ensures the seller gets his payment on time and the buyer gets his purchased securities on time after the settlement.

The clearinghouse ensures liquidity of the market by carrying out clearing and settlement of the securities on time and also makes available more money in the hands of the traders for trading, thereby boosting the liquidity in the market, which enhances the value and volume of traded securities in the stock exchanges.

The efficient clearing and settlement mechanism of the stock exchange eradicates the apprehension of the investors/traders and encourages them to actively take part in the securities market with confidence.

The provision of traded data and the secured mechanism of the clearing houses induce the investors to take informed investment decisions.

Indian securities market witnesses a significant improvement in the market in terms of market efficiency, transparency, liquidity, and risk management due to the introduction of guaranteed clearing and settlement in the market. It also reaped additional benefits in terms of reduced settlement and operational risk, savings on settlement costs, etc. [1].

Clearinghouses facilitate better oversight of regulatory authorities by means of reporting clearing and settlement statistics on a regular basis.

TYPES OF CLEARINGHOUSES

Securities, commodities, and derivatives clearinghouses are different kinds of clearinghouses engaged in the securities market and performing different functions according to their nature and operations. Commodity clearinghouses operate in the commodity markets, and derivatives clearinghouses carry out derivative instruments, namely, futures and options.

FUNCTIONS OF A CLEARINGHOUSE

The stock exchange mandates the trades of the members to be routed through a clearinghouse. The functions of a clearinghouse commence at the moment of execution of orders and are completed after the settlement of trades. In addition to that, it also provides the necessary infrastructure to ensure that the financial institutions interact with others to carry out trading transactions.

Clearing may be bilateral clearing and central clearing. Under bilateral clearing, the parties to the transaction initiate legal action to settle the transactions whereas under central clearing the trades are cleared by third parties.

Clearing

The objective of a clearing is to improve the clearing and settlement process and thereby improve the efficiency of the security market and contribute to the stability of economic development. The main function of a clearinghouse is to clear the securities traded in the stock exchange and settle the same to the parties by ensuring that the sellers get their payment on time and the buyers get their delivery on time. In order to carry out these functions a clearinghouse ensures updated accounts of trading parties and arrangement of the funds and transfer of securities.

Financial Soundness of Parties

Clearinghouses verify the financial soundness of parties, that is, the repaying capacity and credibility of the parties involved before they enter into trade to ensure smooth transactions between parties.

Margin Money

The clearing and settlement involve a high risk of failure of a party to honor their contractual obligations. In order to mitigate this risk and to ensure hassle-free clearing and settlement process clearinghouses are imposing a margin by means of a deposit of a percentage of the total value of the contract, as collateral to ensure parties meet their trade obligations and to protect the parties from the risks of settlement. It also ensures the collection of margin money stipulated and holds it till the completion of the settlement process to ensure the stability of the market.

Guarantee of Trades

The risk of failure of a party to honor their obligations of trade is an inherent nature of the securities market. In order to mitigate such risks, clearinghouses guarantee the completion of trade transactions, especially high-value transactions, irrespective of the failure of a party to the trade to honor their obligations, namely, clearing guarantee.

Terms of Arrangements

The clearinghouse acts upon the arrangement between trading parties in terms of price, quantity maturity date, etc., as the basis for smooth clearing and settlement of trade.

Compliance of Procedures

Clearinghouse ensures that the trading parties duly comply with the bye-laws and procedures set out by the stock exchanges in order to effectively carry out the clearing and settlement process.

Proper Delivery

Clearinghouse ensures that the right quantity of securities is delivered to the right party as per the contractual terms for hassle-free trade.

Maintenance of Records

The clearinghouse maintains and updates the records of receipt, delivery of securities, and funds to the parties to the trade.

Reports

Clearinghouse collects and compiles the data of all trades taken in the stock exchange that are immensely beneficial for the market participants to take informed decisions.

A CLOSE EXAMINATION OF THE CLEARING PROCESS

A buyer may place an order to purchase requisite quantities of securities through the internet or online system of a stock exchange with the assistance of trading members because trading and services of the clearinghouse are restricted to members only and investors/traders can avail these services through members of the stock exchanges.

After the execution of trades, the stock exchange transfers the details of the trade to the clearinghouse on T-day (trading day) and the clearinghouse passes the same to the clearing members/custodians, for confirmation of the trade. The clearinghouse determines the obligations of the trading member/ custodian on receipt of confirmation.

A clearing member maintains a special account/clearing account with the depository to facilitate the clearing of securities of the trade executed at the stock exchanges. It is a transit account by nature that facilitates the securities kept in the account only for delivery to/receipt from the stock exchanges on pay-in/pay-out.

Clearing member/custodian on receipt of details of the obligation with pay-in-advice of funds/securities from the clearinghouse advises the clearing banks to ensure the availability of funds and depositories, the availability of securities on pay-in.

The clearing account assists a clearing member to deliver the securities received from the client to the clearing house on pay-in as well as distribute the pay-out to the clients received from the clearing house. Clearing accounts help to clearing members comply with the requirements of the Securities and Exchange Board of India (SEBI) to deliver the securities purchased within the T+1 days of pay-out [2].

Clearing members instruct the depository participants (DPs) to transfer securities in the clearing accounts to the respective beneficiaries' accounts immediately after the pay-out. DPs carrying out the instructions of the clearing members ensure that the balance in the clearing account shall be brought to nil as stipulated by SEBI.

Members are financially liable for the transactions cleared by clearinghouses. It is their responsibility to ensure the availability of securities for transfer and sufficient margins or to make good on the payments for the shortfall if any. A clearinghouse makes good the shortfall of the transactions of the insolvent firms.

Clearinghouse aggregates transferable securities of each member for the purpose of netting out the transactions for the trading day to facilitate the members of the clearing house to exchange the net payments and securities at the end of the trading day. "Netting" is defined as the determination of net payment or delivery obligations among the clearing members of a recognized clearing corporation by setting off or adjustment of the inter se obligations or claims arising out of buying and selling of securities, discontinuation of business, dissolution, winding-up or insolvency, or such other circumstances as may be specified in the bye-laws of the clearing corporation.

The clearinghouse maintains records of all transactions of the members and generates a report for statistical purposes for the benefit of market participants and regulatory authorities.

Corporate Benefits

The beneficiary position is important for availing the corporate benefits of cash dividends and stock dividend /bonus shares on the record date. The transit nature of the clearing account balances is not considered a beneficiary position and accordingly not eligible for corporate benefits. To address this issue and ensure investors get corporate benefits during the clearing process, SEBI stipulates that the balances lying on the record date shall be credited to the bank/clearing account of the clearing member. Accordingly, the clearing member credit the amount to the client accounts [3].

SEBI directed the clearing members to give instructions to DPs to transfer the securities that are lying in their clearing accounts to the beneficiary accounts immediately after payout [4]. The depository shall ensure that on record date/book closure, the clearing balance shall be nil of that security to ensure corporate benefit shall be passed to the rightful beneficial owner of the securities.

STRUCTURE OF CLEARING ACCOUNTS

Clearing account is internally structured into three types of accounts, namely, pool account, delivery account, and receipt account for better arrangement of accounts and bookkeeping.

Pool Account

It performs the role of clearing securities by pooling securities at the time of pay-in and payout. The clearing member of the seller of securities transfers securities from the seller account to the clearing account before pay-in and after payout, transfers the securities to the buying client account.

Delivery Account

The clearing corporation automatically generates delivery-out instructions on T+1 days in accordance with the net delivery obligations of its clearing members based on the undertaking given by them; otherwise, a delivery instruction has to be given by the clearing member to its DP. Depository clears the securities lying in the delivery account for transfer to the clearing house, at the time of pay-in.

Receipt Account

The receipts account facilitates a clearinghouse to transfer out securities to the pool account on the pay-out day. It also helps to trace the settlement-wise receipt of the clearing member.

PARTIES INVOLVED IN THE CLEARING PROCESS

Clearing Corporation

A clearing corporation, also popularly known as clearinghouse or clearing firm affiliated with respective stock exchanges, acts as an intermediary between traders. A clearing corporation is defined as “an entity that is established to undertake the activity of clearing and settlement of trades in securities or other instruments or products that are dealt with or traded on a recognized stock exchange and include a clearing house” [5] and Reg. 2(1) (o) defines "recognized clearing corporation" as a clearing corporation which is recognized by the Board under section 4 read with section 8A of the Act.

A clearinghouse is responsible for post-trade activities and risk management. Its objective is to monitor, confirm, settle, and deliver trade transactions in the stock exchange. It reduces the cost and risk of settling multiple transactions of multiple parties as a counterparty by assuming the role of buyer for seller and for buyers the role of sellers, is exposed to the risk of both parties [6]. In order to mitigate this risk, they impose initial and maintenance margins to ensure a smooth clearing and settlement process in the market.

Indian Clearing Corporation Limited and National Clearing Corporation are among the clearing corporations that come under the regulatory purview of the SEBI.

India Clearing Corporation

Indian Clearing Corporation Limited ("ICCL") is a “Recognized Clearing Corporation”, incorporated in the year 2007, and acts as the central counterparty. It is a subsidiary of BSE Limited and performs the roles of clearing, settlement, collateral management, and risk management [7].

National Clearing Corporation

NSE Clearing Limited, was incorporated in the year 1995 by NSE. It is a wholly owned subsidiary of NSE, first time in India, introduced a settlement guarantee. SEBI recognized it as a qualifying central counterparty (QCCP). The other notable recognitions are Third Country CCP (TC-CCP) by European Securities Market Authority (ESMA) and TC-CCP by the Temporary Recognition Regime of the United Kingdom.

Clearing Members

The clearinghouse determines the obligations of settlement of the clearing members on the date of settlement to facilitate them to arrange funds/securities in the respective account with clearing banks/depositories. The legal regime simply defines a clearing member as a person having clearing rights in any recognized clearing corporation is called a “clearing member” [8].

Clearing members may be self-clearing members, trading [9] cum clearing members, or professional clearing members. "Trading member" is defined as a person having trading rights in any recognized stock exchange and includes a stockbroker.

Self-Clearing Members

Members under this category clear their own trades/self-trades only and not clear others’ trades.

Trading cum Clearing Members

A clearing and trading member clears and settles their own proprietary trades, client’s trades, trades of other trading members, and custodial participants.

Professional Clearing Members

They are special category members of clearing corporations, especially NSE Clearing Limited (NSECL). They may be banks or custodians, undertake to clear and settle trade executed by their clients only and not trading for themselves, which resembles their role as custodians. They also carry out the clearing and settlement responsibilities of the trading members and institutional clients. They have clearing rights but not trading rights. The financial institutions or brokerage firms who are acting as members of the clearing house, on behalf of their clients routing the trade to the clearing house and bearing the trade-related financial obligations. They have access to services and benefits provided by clearing houses.

Custodians

Custodians are responsible for the safe keep of securities in their custody. They hold documentary proof of securities and the title of the securities in the holder's name. They act as a clearing member only and not trading members and settle the trades as per the instructions/advice of the clearing corporation.

Clearing Banks

The objective of clearing banks is to complete the pay-in and payout. It is the responsibility of clearing banks to provide funds on the payout as per the instruction given by the clearing member. Stock exchanges impanel these banks to facilitate clearing members to operate the clearing accounts. The clearing member ensures the availability of funds in the clearing account on the pay-in and receives payment on payout as the case may in accordance with their obligations determined by the process of clearing/clearing corporation.

Depositories

The legal and regulatory regime stipulates that the market participants have to maintain a demat account with depositories to undertake securities transactions with the stock exchanges. Hence Depositories convert physical securities into dematerialized ones to facilitate the transfer of securities in demat form to comply with the legal requirements. It is very important that the securities shall be made available on the settlement day. The clearing pool account maintained by the clearing members with the clearing house addresses this issue by ensuring the availability of securities on the settlement day. Depositories effect the transfer of securities from custodians/clearing members’ accounts to clearing corporations.

Depository Participants

Depository participants assist investors to maintain their demat account with the depository as an intermediary because an investor is not permitted to open an account with the depository directly.

Single Registration

SEBI permits single registration of stockbrokers and clearing members for a hassle-free clearing process through ICCL [10]. This circular facilitates admission of the existing trading members/clearing members in any Stock Exchange or Clearing Corporation (including ICCL) in any segment as Clearing Members, Self-Clearing Members, or Professional Clearing Members with ICCL in any Segment under "Additional Segment" based on the approval granted by ICCL.

CLEARING RISKS

The risk is the inherent nature of the securities trade. Clearinghouse also encounters risk in the process of clearing securities.

Replacement Cost Risk

In the eventuality of default of the clearing member, the liability to pay the replacement costs arises to a clearing house when they sell or buy contracts that are identical to the defaulted clearing member.

Liquidity Risk

Clearinghouse meets the payment obligations of the defaulting member to the non-defaulting member, in the capacity of a counterparty, and raises requisite funds, based on its assets and financials.

Delivery Risk

It is a significant risk encountered by the clearing houses on two occasions: The seller is at the risk of default by the buyer who took delivery of securities before he pays to the seller and the buyer makes the payment to the seller before the seller delivers the securities.

Counterparty Risk

A clearinghouse has to face the counterparty risk if either party to a trade transaction is not honoring its obligation.

Principal Risk

The seller and buyers fulfill their obligations to deliver securities and receive payment but do not receive payment or do not deliver securities leading to principal risk and clearing house honoring the obligations of the parties.

CONCLUSION

The traders in the securities market encounter the risk of the counterparty that has been mitigated by clearing corporation by imposing appropriate margins on traders and ensuring the trading parties meet their obligations on time and if there is any failure, it steps into the shoes of the party unable to honor his obligations. It makes good the payment and later recovers the shortfall from the defaulting member. The effective risk management of clearing houses gives confidence to the traders to trade in the market. Timely completion of the clearing and settlement of the trades encourages traders to undertake trade with confidence and without the worry of the counterparty risk. In the eventuality of the counterparties failing to honor their obligations, a security guarantee fund is essential to fund the defaulting party. Hence SEBI directed all stock exchanges to set up a settlement guarantee fund (SGF) for the timely completion of the clearing and settlement [11]. The clearing process plays a significant role in the smooth completion of trades. The efficient clearing mechanism of the securities market encourages the savings and investment channeled to the securities market and thereby contributes to faster economic development.

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