THE FINANCIAL EXPRESS

Op-Ed

DEBATE

Should Sebi implement the T+1 settlement system in the capital market?

Yes, time to lay a road map for implementing T+1

Jayanth R Varma

For somebody who specialises in financial markets, a visit to a supermarket is a painful reminder of how primitive the settlement process is in financial markets around the world. In the supermarket, when we buy a product and pay with cash or a debit card, the settlement takes place in real time—trade and settlement are almost simultaneous. The final unconditional transfer of goods happens at the same time as the final unconditional transfer of funds, thereby achieving the highest level of delivery versus payment (DVP). There are practically no financial markets which have either such a short time lag between trade and settlement or such a simple and effective DVP.

Yet we tend to think of financial markets as far more efficient than goods markets. When it comes to trading and price discovery, financial markets are indeed among the most efficient markets in the economy. Paradoxically, these best-in-class trading systems are coupled with such poor settlement systems. Layers of settlement guarantees, auctions, penalties and other mechanisms are needed to achieve a tolerable level of performance under a creaky settlement system.

Historically, settlement systems lagged trading systems because trading required only exchange of information, while settlement required a physical exchange. Even before the advent of modern telecommunications, information could be moved far more easily than goods. Separation of trading from settlement meant that the speed of trading was no longer limited by the speed with which settlement could take place. Today, however, both financial securities and cash are held in electronic form in the depositories and in the banking system. This means that trading and settlement today operate under the same speed limit, namely the speed of the underlying telecommunication system. Technology allows us to abolish the anachronistic separation of trading from settlement.

However, financial markets worldwide have refused to embrace this change. There is a technology called Straight-Through-Processing (STP) that eliminates all the wasteful manual processes in the trading and settlement cycle. However, the move towards this has been too gradual and tardy. Intermediaries who make a living out of the inefficiencies in the current system have resisted this change. Even other intermediaries have little incentive to shift, unless they know that their counter parties will also shift. Some regulatory push may, therefore, be needed to deal with this problem.

The question is whether India should take the lead in this area or let the pace be determined by the United States and other developed markets. I believe India's strengths in information technology give it the ability to assume a leadership role in faster settlements and move towards T+1 settlement.

The experience of other countries that have experimented with short settlement cycles suggests that in practice there are only three obstacles. The first is that short settlement cycles require an efficient domestic payment system. If RBI is now ready with its RTGS payment system, then this is no longer a constraint. The second is the need for an efficient securities lending mechanism to reduce settlement failures. But securities lending is needed even without T+1 settlement.

The third and most important obstacle is that foreign institutions have difficulty in confirming and settling trades in other countries. Straight-Through-Processing will solve most of this problem. The problem that remains is that foreign institutions need to convert domestic currency to or from foreign currency and there is a mismatch in the settlement cycles of the securities market and the foreign exchange market. This problem can be solved by letting foreign institutions hold rupee accounts in India. To prevent these being used for currency speculation, RBI could mandate the use of swaps to ensure that the overnight rupee balance earns only the rate of return of a dollar deposit.

All these problems can, therefore, be solved. The time has come to lay down a road map for transition to T+1 settlement.

The writer is Dean, IIM-A and former member, Sebi

URL: http://www.financialexpress.com/fe_full_story.php?content_id=105794

Print this Story

Expressindia | The Indian Express | The Financial Express | Screen | Kashmir Live

About Us | Advertise With Us | Privacy Policy | Feedback | Labelled with ICRA

Top | Close this window