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An Instant Settlement vision for SEBI beyond T+1

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ABSTRACT

The Securities and Exchange Board of India (SEBI) is trying to revolutionize the Indian stock market through a proposed two-phase rollout of same-day (T+0) and instant settlement. The plan is intended to support the T+1 (trade plus one day) settlement cycle. In a proposed two-phase rollout, the Securities and Exchange Board of India (SEBI) is aiming to revolutionize the Indian stock market with same-day (T+0) and instant settlements. This plan aims to support T+1 (trade plus one day) settlement among Indian stock exchanges by rolling out same-day and instant settlement in two phases. SEBI plans to introduce same-day settlements in two phases in order to support the T+1 (trade plus one day) settlement method. In a push to revolutionize the Indian stock market, the Securities and Exchange Board of India (SEBI) proposes two phases for same-day (T+0) and instant settlement. The plan is intended to support the T+1 settlement scheme. It is SEBI's intention to revolutionize the Indian stock market by rolling out same-day (T+0) and instant settlement. The plan aims to support the T+1 (trade plus one day) settlement system. SEBI intends to revolutionize the Indian stock market through a two-phase rollout of same-day (T+0) and instant settlement. The plan is designed to support T+1 (trade plus one day) settlement. In an effort to revolutionize the Indian stock market, the Securities and Exchange Board of India (SEBI) has proposed two phase-wise rollouts of same-day (T+0) and instant settlement. The plan is intended to support T+1 (trade plus one day) settlement. As part of its proposed two-phase rollout of same-day (T+0) and instant settlements, SEBI is trying to revolutionize the Indian stock market.

KEYWORDS: SEBI, FINANCIAL MARKETS, TRANSACTIONS, SETTLEMENT, PARTICIPANTS.

INTRODUCTION

SEBI’s revelation last year on proposed changes outlined the introduction of a facility for clearing and settlement of funds and securities on T+0 (same day) and an instant settlement cycle on an optional basis. This initiative aims to add a new dimension to the existing one-day settlement cycle, popularly known as the (T+1) settlement cycle. The new – T+0 settlement as the name suggests introduces the possibility of executing and settling trades on the very day they occur until a specified cut-off time. This will provide market participants with fast as well as flexible settlement option. Furthermore, the introduction of an instant settlement cycle allows trade-by-trade settlements until the conclusion of the trading day promoting real-time transactions. These suggested modifications highlight SEBI’s dedication to promoting a more responsive, effective, and dynamic market environment. The suggested change is an intentional endeavour to bring the Indian securities market into compliance with international norms and to create an atmosphere that facilitates quick, safe, and effective transactions. As SEBI explores these revolutionary changes, the consultation paper serves as a catalyst for in-depth discussions among stakeholders, market experts, and policymakers, ushering in a new era for settlement cycles and shaping the future landscape of India’s financial markets.

SETTLEMENT CYCLE: MEANING AND ITS EVOLUTION IN INDIAN SECURITIES MARKETS

The settlement cycle in financial markets refers to the time frame within which securities and funds are exchanged between buyers and sellers after a trade is executed. It plays a crucial role in ensuring the smooth functioning of the securities market by facilitating the transfer of ownership and funds between market participants. In order to comprehend the settlement cycle, let us use the example of someone who decides to sell a share they hold for Rs. 10 lakh. If it is sold on a Monday, it does not guarantee that the Rs. 10 lakh will show up in the seller's bank account that same day. The settlement process has a lag in time. The settlement in the stock market is commonly represented as T+1, where T is the transaction date. As a result, if one sell shares on Monday (T), the settlement will take place on Tuesday (T+1), at which point that person will be able to access the fund of Rs. 10 lakh. A distinction exists between the transfer to a Demat account and a bank account. While the sale of shares may promptly reflect funds in your Demat account, the subsequent transfer to one's bank account does not occur instantly. This disparity introduces a delay in the overall settlement process. As of January 2022, the T+1 settlement cycle was fully implemented in India and henceforth India became the second nation after China to operate on a T+1 settlement cycle. No other nation has implemented a system that requires instantaneous settlement. Over time, the Indian securities markets' settlement cycles have experienced notable alterations that are indicative of the constantly changing financial landscape and the imperatives of efficiency, transparency, and risk mitigation. The following paragraphs give an account of the evolution of Indian settlement cycles:

Early Years (Before 2003): In the early years, the settlement cycle in India followed a T+5 (Trade date + 5 days) system. This means that it took five days from the date of the trade for the actual transfer of securities and funds to occur. However, this cycle was considered lengthy and exposed market participants to higher risks, including counterparty risk. Then, in 2002, a change occurred, and the settlement cycle was reduced to T+3

Reform in 2003 – Introduction of Rolling Settlement: India changed to a two-day settlement period in April 2003 by implementing a T+2 rolling settlement cycle. The purpose of this action, referred to as the Rolling Settlement, was to improve market liquidity, lower systemic risks, and comply with global best practices. It greatly increased the securities settlement process's efficiency.

Dematerialization, Electronic Trading, and Regulatory Reforms: The settlement cycle in the Indian securities markets has been greatly simplified by the combination of dematerialization, computerised trading, and regulatory reforms. The shift from paper-based transactions to electronic ones, made possible by organisations such as National Securities Depository Limited (NSDL) and Central Depository Services Limited (CDSL), has simplified the process and decreased the possibility of fraud. It has also expedited the trade settlement; real-time access is made possible by electronic trading systems, which improve the accuracy and speed of transactions. The RBI expedited the settlement process by introducing the Real-Time Gross Settlement (RTGS) technology, which guarantees safe and prompt fund transfers. The regulatory reforms implemented by SEBI, which prioritise transparency and strong risk management, have increased market players' trust. The efficiency and integrity of the settlement cycle of the Indian securities markets are strengthened by this all-encompassing strategy, which also conforms to international norms.

Currently followed T+1 Settlement: A phased transition to T+1 began, starting with smaller stocks and gradually moving to larger cap stocks. The full migration was completed in January 2022.

Future proposals: SEBI has proposed introducing an optional T+0 settlement for intraday trades and even instant settlement in the future. This would further expedite the process and enhance market efficiency. In summary, the settlement cycle history of the Indian securities markets shows a persistent attempt to adjust to shifting international standards and market conditions. A more reliable and effective market infrastructure has been created by reforms including rolling settlement, dematerialization, and real-time settlement systems, which have also decreased risks and increased investor trust.

OBJECTIVES AND RATIONALE BEHIND PROPOSED CHANGES

In November 2021, the National Stock Exchange (NSE), Bombay Stock Exchange (BSE), and Metropolitan Stock Exchange (MSE) collaboratively announced the gradual implementation of the T+1 settlement cycle, which officially commenced on February 25, 2022. The phased rollout began with a focus on the bottom 100 stocks and expanded monthly, encompassing the subsequent bottom 500 stocks until January 2022. Subsequently, on January 27, 2022, India's domestic equity market seamlessly transitioned to the T+1 settlement cycle, showcasing the successful execution of this transformative initiative and encouraged by this accomplishment, SEBI put forth a ground-breaking proposal by end of 2022 – a facility for the clearing and settlement of funds and securities with T+0 settlement (same day) and an instant settlement cycle, offered on an optional basis, has been proposed by SEBI and is expected to go into force by year's end. This innovative step puts India at the forefront of financial innovation worldwide and indicates a significant improvement in the effectiveness and speed of its securities settlement procedures. The aforementioned modifications demonstrate a dedication to cultivate a lively and adaptable marketplace, reinforcing India's position as a leader in the international financial sphere.

SEBI's proposal to augment the current T+1 cycle for equities cash trades with optional T+0 and instantaneous settlement options is motivated by a strategic set of objectives. The initiative's primary goal is to improve market efficiency by cutting the settlement period dramatically. This promotes better liquidity and market dynamism by accelerating capital reinvestment and lowering the danger of future defaults. The improvement of investor protection is yet another important objective. Investors have more control over their assets and a more safe and transparent trading environment when funds and securities are received immediately since settlement risks are eliminated. Furthermore, SEBI believes that a quicker settlement cycle will increase the appeal of Indian markets internationally. This action, which complies with international norms, may attract more foreign investment and strengthen the market by increasing competition. Additionally, the proposal caters to the diverse needs of investors by providing flexibility in settlement timeframes. Investors can customise their preferred settlement options according to their demands and risk tolerance because both optional T+0 and instant settlement are available with the conventional T+1 cycle.

However, it is crucial to acknowledge the challenges associated with these proposed changes, including operational burdens on clearing houses and brokerages, technological infrastructure upgrades, investor awareness, and the potential for misuse and increased volatility. Despite these obstacles, SEBI's plan shows a dedication to ongoing market development, and the possible advantages present a promising chance for additional expansion and efficiency. As the proposal undergoes development and SEBI seeks feedback, the final details may evolve based on the insights and suggestions from market participants.

TWO-PHASED IMPLEMENTATION STRATEGY

The Securities and Exchange Board of India has proposed a phase-wise transition to instant settlement of trades in the equity cash market.

Phase 1: Optional T+0 Settlement (Same Day Settlement till 1:30 pm) In the first phase, SEBI may introduce an optional T+0 settlement cycle for trades made until 1:30 pm. This means that the settlement of funds and securities for these trades would be completed on the same day by 4:30 pm. Initially, this T+0 settlement will be available for the top 500 listed equity shares in three stages, starting from the lowest to the highest market capitalization.

Phase 2: Immediate Trade-by-Trade Settlement (Till 3:30 pm) In the second phase, an optional immediate trade-bytrade settlement will be carried out for trades made until 3:30 pm. An API-based interface will be built to enable real-time communication between depositories and clearing corporations for early pay-in. All securities available under phase 1 will also be available in phase 2. SEBI's transition to faster settlement cycles in the equity cash market is driven by key objectives: facilitating quicker payouts of securities and funds to investors and enhancing overall market efficiency while improving risk management for clearing corporations.

Certain securities, such as those under trade-for-trade settlement and those traded in periodic call auction sessions, will not be permitted for T+0 settlement. Additionally, the use of only limit orders for instant settlement is proposed to validate pre-funding adequacy by clearing corporations against the limit price. Hence, this phased approach reflects SEBI's careful consideration of various market nuances as it strives to bring about positive transformations in the Indian equity cash market.

APPLICABILITY OF T+0/INSTANT SETTLEMENT TO TOP 500 COMPANIES

SEBI's proposed phased implementation of T+0 and instant settlement will initially be applicable to the top 500 listed companies by market capitalization. This concept of focusing on the top 500 firms will have certain potential advantages and disadvantages and the same are discussed below:

Advantages

Stability and Resources: The top 500 companies are generally considered financially stable and equipped with the necessary resources. This financial robustness positions them favourably to implement the upgraded infrastructure and risk management systems required for faster settlement.

Reduced Risk Exposure: By targeting larger companies initially, the proposal aims to minimize potential systemic risks in the event of implementation challenges. This cautious approach seeks to mitigate the impact on the broader market.

Liquidity Boost: Faster settlement for larger market players has the potential to significantly enhance market liquidity and efficiency. This can positively impact overall market dynamics and investor participation.

DISADVANTAGES

Exclusion of smaller companies: Smaller companies might feel disadvantaged at the initial stage, potentially hampering their access to faster settlement benefits.

Investor access disparities: Investors in smaller companies could face limitations in capital access compared to those in T+0/instant settlement eligible firms. Hence, in order to ensure a smooth implementation, SEBI's phased T+0 and instant settlement strategy first targets the top 500 businesses, taking advantage of their stability and resources. Although this strategy lowers systemic risks and increases liquidity for major participants, it raises questions regarding possible early exclusion and unequal access for smaller businesses and investors.

IMPLICATIONS OF SEBI'S PROPOSED MOVE

The proposed shift towards T+0 and instant settlement in the Indian stock market by the Securities and Exchange Board of India (SEBI) has ignited discussions about its potential advantages and apprehensions. Here is a breakdown of both aspects:

EXPECTED BENEFITS

Reduced Settlement Risks: In a T+0 settlement system, the time gap between trade execution and settlement is eliminated. This immediate settlement reduces the exposure to counterparty risk, as the parties involved in the trade do not have to wait for an extended period for the transaction to be finalized. This can significantly decrease the likelihood of default or other unforeseen events impacting the completion of the trade.

Diminished Need for Margining: With T+0 settlement, there is less need for margin requirements. Margin is often required to cover the risk associated with the time lag between trade execution and settlement. As settlement occurs instantly, the need for holding large amounts of margin is reduced, freeing up capital that traders can deploy elsewhere. This can be particularly beneficial for investors and institutions as it lowers the overall cost of participating in the market.

Fostering a More Cost-Effective Trading Environment:

The combination of reduced settlement risks, and diminished margining needs contributes to an overall more cost-effective trading environment. This can attract more participants to the market and encourage higher trading volumes. Increased liquidity and participation can further enhance market efficiency by tightening bid-ask spreads and reducing price volatility.

Enhanced Transparency: Real-time settlement provides a unique opportunity for greater transparency into market activities. This heightened visibility can bolster investor confidence and empower them with timely information for informed decision-making.

Global Competitiveness: India will be more competitive on the world stage if it adopts a quicker settlement cycle in line with international best practices. The country's financial market may get stronger as a result of this alignment drawing in global investment.

Capital Optimization: A faster settlement cycle translates to capital being freed up sooner for both investors and companies. This accelerated capital turnover allows for more efficient reinvestment or utilization of funds, potentially driving economic growth.

CONCERNS

However, the proposed shift to T+0 settlement also raises valid concerns that merit careful consideration:

Technological challenges: India has many technological obstacles in the way of implementing fast settlement. To successfully process real-time transactions, the financial markets' enormous and diverse infrastructure must be scalable. Getting beyond problems with the current network infrastructure is essential to setting up dependable channels of communication.

Increased Volatility: The faster settlement process might lead to heightened market volatility, particularly during periods of uncertainty or high trading volume. This volatility could disproportionately impact retail investors, necessitating measures to safeguard their interest.

Impact on Brokerages: Traditional brokerage revenue models may face disruption, potentially pressuring these entities to reevaluate their commission structures and service offerings in response to the shift to T+0 settlement.

Manipulation Risks: The faster settlement cycle might offer increased opportunities for market manipulation through strategies like spoofing or wash trading. Implementing robust regulatory measures and surveillance systems is essential to counteract these risks.

Investor Protection: During the shift to T+0 settlement, it is essential to guarantee sufficient investor protection and education. The transparent information dissemination and accessible risk management tools are vital components in safeguarding investors as they adapt to the faster settlement cycle.

Liquidity Fragmentation and price discovery: There are also concerns regarding potential liquidity fragmentation and efficient price discovery due to the coexistence of different settlement cycles, notably T+0 and T+1. The existence of divergent settlement periods may pose challenges to maintaining a cohesive market, potentially leading to discrepancies in liquidity across segments. For the same, SEBI has suggested mitigating price divergence by introducing price bands and enabling arbitrageurs to bridge gaps between these settlement cycles.

Finally, while the transition of the Indian stock market to T+0 settlement holds significant potential for efficiency improvement, effectively addressing and navigating associated challenges is paramount for ensuring a robust and successful implementation. In order to strike a delicate balance that optimises possible benefits while successfully reducing risks, ongoing stakeholder involvement and thorough analysis are essential. To

ensure a seamless and resilient transformation of the stock market infrastructure, striking this careful balance is crucial. This balance will encourage stability and instil confidence of stakeholders in the evolving financial landscape.

CONCLUSION

In the growth of the Indian financial sector, SEBI's ambitious desire for quick settlements in the market marks a turning point. This action has the capacity to be revolutionary, as seen by the possible advantages it may bring about, including increased productivity, less risk of settlement, and improved competitiveness worldwide. However, this vision is not without its share of concerns, including fears of increased market volatility, susceptibility to manipulation, and the essential aspect of technological preparedness. A phased rollout of this plan is necessary to address concerns and allow market participants and infrastructure to adjust systematically.

This strategy avoids the risks that come with quicker settlement cycles by integrating strong safeguards, such as improved regulatory controls and surveillance technologies. In order to ensure that SEBI's objective of immediate settlement is realised, it is necessary to continuously evaluate and provide feedback mechanisms.

While acknowledging the positive impact on efficiency and risk reduction, a collective effort to address concerns is essential for the transformative initiative's success, ushering in a dynamic and inclusive era in the Indian financial market.

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