Expanding the Custodian's Role in Settlement for India's HNIs

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25th September 2018

Indian retail investors (non-institutional) have been settling equity trades through brokerage firms since 1875, embracing complex products and multiple settlement systems. This was when banking was not yet developed, and professional clearers did not yet exist. Most brokerages were locally-based members of a single exchange or clearing corporation, and clients looked at their brokers as a one stop shop in the absence of viable alternates.

Fast-paced changes and resulting complexities

India's capital markets have since expanded and become more diverse and complex. SEBI (the Securities and Exchange Board of India) and SROs (self-regulatory organisations) have ensured that risk management in a large country like India worked well, even as banking services evolved. Clearing corporations now permit clearing participants – Professional Clearing Members (PCMs) including custodians and banks – to settle the trades of institutional clients.

However, multiple products led to multiplicity for regulators in their rules, regulations and byelaws – for exchanges, depositories, clearing corporations, product segments (including equity, ETF, derivatives, commodities, fixed income, etc.), settlements systems, intermediaries and locations. This multiplicity added risks, complexities, higher costs and inefficiencies, hindering the growth of capital markets and intermediaries, as well as sometimes compromising on investor protection.

Meanwhile, HNI (high net-worth individual) trades have grown significantly and will continue to grow, fueled by an increasing number of investible assets, larger IPOs, a fast-growing economy, greater investible surpluses, an active secondary market and a sharp increase in the number of HNIs with an appetite for investment.

Challenges of existing settlement systems

While trading systems are similar whether for institutional or non-institutional clients, the challenge is the multiplicity of settlement systems. These challenges are also distinguished by the classification of trades as institutional and non-institutional:

1. **Brokerages**: Brokerages deal in multiple segments – institutional, PMS (portfolio management services) and retail; hence they need to have a team that settles with PCMs (in case of institutional clients) as well as with clearinghouses (non-institutional). This adds operational complexities increasing operational risks, costs and inefficiencies. Specialised staff are in short supply as new segments are added. Geographical spreads also

contribute to the complexity, together with ever-changing operational and technological requirements. Other challenges adding costs include evolving banking processes, longer trading hours at exchanges, tight cutoff times of clearinghouses which are different from depositories and banks, a lack of interoperability between clearinghouses and varying needs of client segments.

Client failures to fund margins lead to greater financial stress on brokerages, who may pass this on to clients through higher trading costs. Brokers also need to maintain additional margins to settle the trades of their non-institutional clients. Settlement infrastructures at brokerages are being tested, with failures leading to auctions and, in some cases, defaults that can lead to bigger crises.

2. **Custodians**: Custodians have separate processes for HNI derivatives settlements and for other segments in case of institutional clients, while they also have to coordinate with clearing corporations. However, with regard to equity settlements for non-institutional clients, custodians interact with the clearing participant directly, most often a broker. This duality confounds the client and custodian relationship, while also impacting settlement and cashflow with regard to the derivatives and equity segments with each segment handled by separate entities. This adds costs for the investor.

3. **Clearing Banks**: There is huge pay in and payout pressure placed on banks for clearing funds at the RBI (Reserve Bank of India), which is borne by the investor.

4. **Clearing Corporations**: The increasing number of product codes (such as for equities and derivatives), a large number of counterparty codes (including for brokers), delays in settlement, and failures resulting in auctions contribute additional costs to clearing corporations. The stress resulting from guaranteeing settlement for broker exposures is a significant challenge for clearing corporations.

5. **Clients**: The risk to clients relates to requirements to maintain large balances with brokerages towards their margins. The brokerage may use clients funds to post margin for other clients and for the broker's own trades.

Expanding the custodian's role in settling HNI trades

SEBI regulates 18 custodians, 11 of which are SCCs (Single Country Custodians) with sophisticated settlement capabilities, skilled resources, nationwide presence and robust technology that have helped de-risk the settlement of institutional trades. Custodians possess the financial resources and wherewithal to effect better practices than most brokerages and have therefore made the system more secure. Being independent, they have been trusted by the large institutions, exchanges, clearing corporations and other market participants. Meanwhile, brokers have sometimes failed to settle trades, putting investor interest at risk.

Establishing a practice whereby custodians settle all HNI trades will de-risk and expand India's capital market, improve transparency and governance, reduce settlement costs and risks, while maintaining consistency with policies for Category III FPIs. As current laws do not prohibit settlement of trades by custodians, no regulatory changes are needed. The superior practices of professional clearers can better protect retail investors. Benefits to other stakeholders include:

Institutional Clients: No change in status. No adverse impact.

Non-institutional client: Assure third party settlements; enable securities lending; remove exposure to brokers; maintain confidentiality of settlements, provide access to other custodian services; reduce margins held with each broker; enable trading through multiple brokers.

Clearing Corporations: Standardise practices; boost revenues; reduce the number of counterparties; reduce cost of multiple settlement practices; leverage on existing structures; reduce reliance on guarantee fund; reduce risk to settling pledged stock and margin funding.

Depositories: Reduce pressure.

Custodian: Additional asset under custody; improved capacity utilisation; securities lending; new revenue stream; more integrated service to existing (derivatives settlements) and new clients; improved client confidentiality.

Brokers: Significantly reduced operational costs; greater concentration on core business; reduced technology costs; in line with global norms; reduced impact of resources attrition.

Exchanges: Less risky settlement; faster go-to-market for product (without waiting for brokerages to effect change); improved risk measures; greater investor protection; standardisation of practices.

Banks: Reduced risk while settling pledged stocks directly between bank and clearing corporation.

Tax Authorities: Centralised settlement generated reports of gains and losses.

Issuers of PMS products: Single entity to deal with for trade settlement; fewer specialised operations teams needed; reduced costs; more secure settlements; better client service.

It is important to note that a major share of India's retail sector is small-ticket sized and thus a roll-out for non-HNI investors will add significant costs with no corresponding benefits to investors or intermediaries. Depositories will also not be suited to performing this function, as it would only lead to further fragmentation with no benefits, given their roles and competencies.

We advocate that given the multiple and diverse benefits to investors, SROs and intermediaries, SEBI should consider mandating settlement for HNIs through custodians. It's our belief that a majority of the custodians, especially the 11 Indian SCCs, are well equipped to service this new class of clientele.

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