

Securities Market Infrastructure Trends in India

Continuous improvements in infrastructure and increased sophistication of available products are inevitable consequences of the rapid development of the Indian capital markets. **Debopama Sen**, Securities Country Manager India, Citigroup Global Transaction Services, summarises the major changes that are anticipated by the market in the coming months, and assesses their likely implications for foreign investors.

It is a well-established truth that the Indian capital markets have taken significant strides in the last decade. The reforms undertaken by the Government over the last decade have not only refined and modernised the market infrastructure, but increased the attractiveness of the Indian capital markets to global investors. The fiscal year 2004-05 saw net investments from Foreign Institutional Investors (FIIs) reaching USD 10 billion, with total net FII investment standing at USD 35.9 billion as of March 31, 2005.

Making India “a benchmark for the globe” is the mission statement of the Securities and Exchange Board of India (SEBI). The continuing inflow of foreign investment, the seamless implementation of T+2 settlement, and the rapid growth of the derivatives market are testaments to the fundamental resilience and structural strength of the securities market.

Continuous improvements in infrastructure and increased sophistication of available products are inevitable consequences of the rapid development of the Indian capital markets. We summarise below the major changes that are anticipated by the market in the coming months, and assess their likely implications for foreign investors.

1. Enhancing the corporate bond market infrastructure

SEBI had identified the need to build further transparency in India’s corporate bond markets in its Strategic Action Plan for 2004-05. In his 2005-06 Union Budget speech, the Finance Minister of India announced that a committee of experts would look into the changes that are required to make the corporate bond market as vibrant as the equity capital markets. The Committee will look into legal, regulatory, tax and market design issues. The corporate debt market today in India is an over-the-counter market

with bilateral settlement taking place directly between counterparties due to the absence of a central clearing house. It can be expected that the infrastructural measures recommended by the Committee would aim to build the same transparency and risk containment measures that exist in the equity markets today.

Citigroup in India has played an active role in the fixed income market in India, contributing to the setting up of the core infrastructure for central counterparty-based clearing and settlement for government securities and foreign exchange.



2. Extending Straight through Processing to the derivatives and debt markets

Straight through Processing (STP) was successfully introduced in the equity capital markets in 2002-03. In 2004, SEBI mandated STP for all institutional transactions executed through the stock exchanges, which has ensured STP for the equity capital markets. However, the process flow for debt and derivatives trading and settlement continues to be manual and paper-based.

The equity exchange traded derivatives segment in

Citigroup India: A Key Player in the Development of India's Market Infrastructure

Citigroup India is a member company of Citigroup, the largest and the most diversified provider of financial services in the world. In India, with over a 103-year history and a network of 37 branches, Citibank has come to be acknowledged as one of the leading international banks in the country with a track record of outstanding business milestones. Citigroup's Global Transaction Services is the leading provider of Electronic Banking Solutions, Cash Management, and Trade Services globally with Transactions Services business volumes in India of over USD 100 billion in 2004 across Cash Management, Trade Services and Securities Services. Some of the business highlights for 2004 include:

Cash Management – USD 38 billion of collections

and payments representing approximately 8% of India's GDP.

◆ **CitiDirect Online Banking** – global award winning platform which saw a growth of 108% in usage volumes during 2004.

- Over 5800+ users in India.
- Over 2 million transaction processed in 2004 with value of USD 22 billion.

◆ **Capital Markets** – Leading custodian in India with assets under custody of USD 23 billion.

◆ **FX Volumes** – Citibank is India's largest foreign bank in the foreign exchange market with a 14% market share.

India has seen explosive growth since the commencement of trading on the exchanges in 2000 with average daily traded value being in excess of USD 3 billion currently. In April 2005, the FII share of open interest in the futures and options segment reached an all time high of 42%, an indication of the significant interest shown by FIIs in the segment. It is likely that the existing infrastructure for ensuring STP in the equity markets will be suitably enhanced so that it may operate in the derivatives and debt markets. Citigroup was a key member of the SEBI task force in 2002-03 for introduction of STP in the local market.

3. SMILE taskforce recommendations

In April 2004, SEBI established the Securities Market Infrastructure Leveraging Expert (SMILE) taskforce to carry out a thorough "health check" of the securities market. Citigroup is the only foreign bank and custodian to participate on the SMILE taskforce. In August 2004, SMILE published a report entitled "*Infrastructure and Process Flows for the Primary Market*" recommending increased automation in the entire process flow from confirmation to allotment to refunds. In January 2005, the taskforce published "*Infrastructure and Process Flows for Enhancing Distribution Reach in the Mutual Fund Industry*." The SMILE taskforce's recommendations are under review for implementation.

The SMILE taskforce's recommendations for the primary market related to automating the primary market process in its entirety – from confirmation to allotment and refunds – with the aim of reducing manual entry and avoidance of duplicate records. The taskforce's suggestions to the mutual fund industry was to evaluate enhancing their reach by leveraging the existing depository infrastructure as an alternative to the existing collections centre model.

4. Structural changes to payment and settlement infrastructure

India's payment and settlement system currently involves a variety of payment instruments – both paper-based and electronic. Settlement is characterised by the presence of multiple clearing houses (about 1050) handled by various legal entities. The clearing houses are voluntary bodies set up by the participating banks and post offices and they function in an autonomous manner. Due to the multiplicity of operators, local practices vary from place to place, which may lead to a lack of coordination among organisations resulting in inconsistency of operations. This also limits the scope of implementing innovations in the systems.

In its vision document titled "*Payment Systems – Vision 2005-08*", the Reserve Bank of India (RBI) has envisaged the Indian Retail Clearing function being entrusted to a separate single legal entity while the RBI remains the settlement institution for all clearing systems.

The single entity having uniformity in structure, operations and procedures will facilitate standardisation and efficiency in the processing of smaller value payments. Citigroup India is a member of the National Payments Council constituted by the RBI.

Real Time Gross Settlement (RTGS) is expected to revolutionise the payments infrastructure in the country. The expansion of RTGS has been hampered by the relatively low penetration of technology in public sector banks. A reduction in operational costs will hasten the adoption of RTGS for securities settlements and reduce usage of paper-based instruments in the country. Citigroup has won the

The Development of India's Market Infrastructure: Significant Milestones

Since the establishment of the Securities and Exchange Board of India (SEBI) as the securities markets regulator in 1988, much progress has been made in the modernisation of India's market infrastructure. The developments, which are expected in the coming months, are the latest of a large number of initiatives, which have been adopted so far. Significant milestones so far include the:

- ◆ Replacement of open outcry trading with screen trading at the major stock exchanges.
- ◆ Shortening of the settlement cycle from 30/14 days to a rolling T+2 settlement cycle.

- ◆ Introduction of dematerialisation.
- ◆ Launch of derivatives trading.
- ◆ Implementation of risk management measures.
- ◆ Establishment of the Clearing Corporation of India Limited (CCIL) as the clearing house for Government Securities and Forex.
- ◆ Introduction of the Market Participants and Investor (MAPIN) database.
- ◆ Launch of the Indonext Trading Platform on the BSE for Small and Medium Sized Enterprises.
- ◆ Introduction of Real Time Gross Settlement (RTGS).
- ◆ Implementation of mandatory Straight Through Processing (STP) for institutional equity trades.

prestigious "Best Payments Initiative" Award in the Indian Banks Association's Banking Technology Awards 2004 for its RTGS initiatives.

5. Further progress towards adoption of a T+1 rolling settlement cycle

SEBI has envisaged a T+1 rolling settlement cycle for equity trades. This is likely to become more practicable as RTGS becomes more widespread. Other key considerations include the presence of a banking sector infrastructure able to support T+1, automation of broker back-offices in line with T+1 and the complications arising due to foreign investors and global custodians having operations and dealing rooms in multiple time zones. It remains to be seen whether the challenges of working with investors in multiple time zones hinders the introduction of a T+1 settlement cycle.

6. Maturity of the derivative markets

The rapid growth of the derivatives market in India has been remarkable. The basket of derivatives is expected to be expanded based on various instruments available internationally. Index futures and options may be extended to other indices and stocks while stock futures and options could be extended to active securities. In April 2005, the National Stock Exchange (NSE) announced the phased introduction of futures and options contracts for 70 additional individual securities as against 55-odd existing securities till then.

It is possible that new derivatives, based on the exchange rate, gold or international instruments will be introduced in the future.

Foreign Institutional Investors (FIIs) till now have had to deposit cash for collateral to satisfy margin requirements for derivatives trading. In the coming months, SEBI and the exchanges are expected to

publish guidelines that will enable FIIs to post securities as collateral. At this stage, however, it seems unlikely that physical – as opposed to cash – settlement of derivative contracts will be possible before the second half of 2006.

7. Implementation of securities lending and borrowing

The absence of a widespread program of securities lending and borrowing has been a limiting factor to the introduction of the physical settlement of derivatives contracts. However, securities lending and borrowing is expected to be introduced to handle settlement shortages by 1 June 2005. The program may be extended to a wider base after a period of 1 year.

Summary

The Indian securities markets remain unique by virtue of its multiple exchanges and depositories. The next three years would be crucial in the continuing development of the Indian capital markets as they will give direction and pace to the infrastructural and product reforms that are transforming the face of the securities market. The reforms in the corporate debt market could herald in the era of anonymous order driven trading and a clearing house model of settlement – as distinct from the existing OTC trading and bilateral settlement that is in vogue today. The widespread adoption of RTGS may build the necessary infrastructure for an efficient payments system. The adoption of automation in the primary market would address the existing gap between the secondary and the primary markets.

As the leading custodian bank in India, Citigroup is an active participant in all industry forums on these and other market changes. For more information, please contact your local Citigroup Global Transaction Services representative. ●