

Dematerialising Indian finance

Exactly 26 years ago, India embarked on a very ambitious path in digital finance leading to remarkable results. It is time for more such reforms



The number of dematerialised accounts in India recently crossed 100 million. Given India's population, large numbers can be obtained in many fields — but each of these milestones is backed by a reforms programme of imagination and execution. The remarkable success of securities dematerialisation is a story of high quality legislation, thoughtful institution-building, leadership and risk-taking, and genuine co-operative federalism.

A depository is, simply, an abode for safe-keeping of valuables, where the ownership record of these valuables can change on a computer system. As with so much else about the early years of the Securities and Exchange Board of India (Sebi) and the National Stock Exchange (NSE), there hangs an interesting tale.

In 1993, when foreign institutional investor (FII) investment first surged, the settlement system at the Bombay Stock Exchange (BSE), that used physical shares, choked. Households in India who were investing in equities were perennially harassed by bad deliveries and fake certificates. The Stock Holding Corporation of India proposed building a depository by "immobilising" share certificates that were to be stored deep in a mountain in the Western Ghats. The NSE leadership, instead, proposed to go one step further, and eliminate the physical share certificates with "dematerialisation", at about one-sixth the cost. This kind of depository was first incubated within NSE, and then spun-out as the National Securities Depository Ltd (NSDL).

This required big legal changes. The critical milestone was the Depositories Ordinance in September 1995. The word "demat" is India's contribution to the English language, as it was used for the first time in this Ordinance.

There was considerable legal complexity faced in going to all-electronic securities ownership. After dematerialisation, in the register of the company that has issued the securities, the name of the depository is registered as the owner of the securities. The investor's name is recorded in the depository as the beneficial owner. The depository does not have any voting rights or any other economic rights in respect of the shares as a registered owner. The beneficial owner continues to enjoy all the rights and benefits and is subject to all the liabilities. An agent of the depository called the depository participant is the link between the investor and the depository and provides the depository services to investors. Legally, this domain had direct links with at least seven other pre-existing laws dealing with companies, stamp duty, securities, income tax, evidence & benami transactions.

This chess puzzle was solved in a remarkable piece of legislation of just about 30 sections. Yet the Act of 1996 — which replaced the Ordinance — has not required even one substantive amendment.

The transformation of the Indian securities markets was led by a new breed of institutions. In chronological order, there was the NSE, National Securities Clearing Corporation (NSCC) and then NSDL. The NSDL was an entity that was a for-profit private company, entrusted with public interest functions of a property rights depository. A somewhat loose parallel, which illustrates how remarkable this is, would be a private for-profit company that substituted for sub-registrars who record land transfers.

This design and structure were necessary, given that good talent in finance and IT require market benchmarked compensation, and the domain required the fast and non-bureaucratic decision-making of a private company. These organisations are

able to take rapid decisions, take risks, not be bound by government procurement processes, recruit from the private labour market, and deliver technological progress with cost efficiency to the user community. Under regulatory oversight, these institutions have steadily cut prices as volumes have grown.

The depositories legislation had, all along, anticipated the problems of a monopoly, and laid the foundations for a pro-competitive environment. This made it possible for the BSE to build a competitor to NSDL, called the Central Depository Services Ltd (CDSL). Today, CDSL has more accounts than NSDL.

Indian state governments played a key role in this game-changing reform. According to the Stamp Act, the revenues from the duty levied on a variety of instruments, including securities, are assigned to states. The stamp duty rates for select instruments are to be decided by the Government of India (GoI) and the balance instruments by states. In addition, acting on an entry in the Concurrent List of the Constitution, many states have made their own stamp duty legislation. As a result, India had differential rate structures on the same instruments across states. This was completely out of sync with the pan-Indian securities market that was created with screen-based trading enabled by dematerialisation. Hence, uniformity and reasonable levels of the stamp duty structures for securities across India were desirable. The 1995 Ordinance exempted stamp duty on dematerialised equity transactions. The scope of this exemption was expanded in 1997. The comprehensive amendment of 2019 has led to a stamp duty neutral regime for all securities across the country. States saw the merit of a national approach to this issue and cooperated with the Ministry of Finance in reaching a consensus on this very difficult subject.

The NSDL started operations in November 1996, and there is a direct thread from this institutional capacity to the design of the New Pension System, where Project OASIS (chaired by S A Dave) envisioned a "Central Recordkeeping Agency" that would store facts about each pension system participant for decades and support frictionless transfers from one pension fund manager to another. Similarly, the NSDL was the institutional foundation for building the Tax Information Network for the income tax system.

The techniques that have been mastered at NSDL and CDSL can be extended in many directions. These depositories can readily store government bonds, and securities for issuers (either private or governments) overseas. There is thus considerable future potential in these institutional capabilities.

We are all proud of milestones like a 100-million demat accounts. These wins are grounded in the visionary work of the founders of the modern Indian equity market, at the Ministry of Finance, at Sebi and at NSE, over 25 years ago. We as a country need to embark on many more such journeys.



**AARTHIKAM
CHINTANAM**

K P KRISHNAN

The writer is an honorary professor at CPR, member of a few for-profit and not-for-profit boards, and a former civil servant