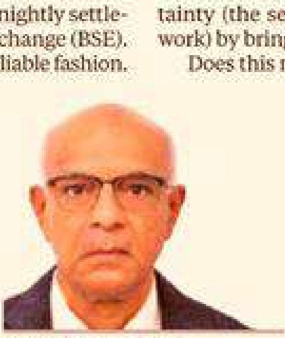
ILLUSTRATION: BINAY SINHA

Equity market: Speed versus quality

Reducing transaction time beyond a certain threshold may not enhance equity market quality. On the contrary, it could reduce participation and diversity and harm the markets



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The Securities and Exchange Board of India (Sebi) is contemplating dramatic reductions in equity market settlement time. Is a reduction in transaction settlement time, like this one, always a good thing?

In the early 1990s, there was a fortnightly settlement system at the Bombay Stock Exchange (BSE). In addition, the BSE worked in an unreliable fashion. When you sold shares, there were delays of a fortnight or more. This made shares illiquid. If you needed money, you could not quickly sell shares and get it. Shares were not as bad as real estate, but selling shares was a time consuming and unreliable process.

After the establishment of a statutory Sebi in 1992 and with the creation of other new institutions like the National Stock Exchange (NSE), settlement became a weekly process. Importantly, it became more predictable. There was a dual benefit: A gain in settlement time going down from a fortnight to a week, and the gain in predictability, because the NSE system worked like clockwork. When shares were sold, the money reliably came in within a week. The great changes in 2000 introduced "rolling settlement", where settlement happened on T+5 (shares sold on Monday yielded money next Monday) and then T+3 (shares sold on Monday yielded money on Thursday).

Thanks to these measures initiated about two decades ago, shares were (and are) a highly liquid asset. You could hold your money in shares, and in case of a sudden need for money, you could sell shares on a Monday and get your money with 100 per cent reliability on Thursday. The equity market reforms had done a great job in removing uncertainty (the settlement process worked like clockwork) by bringing the time down to three days.

Does this mean further reducing the settlement time to two days or one day is necessarily better? Or should one consider a system where there is no delay at all? For example, can we have a system where shares are sold at 2:00 pm and the money is obtained by 2:01 pm? After all, we are in digital nirvana and with computers, anything is possible!

Perhaps, not so fast!

Let us think more about the entire transaction process. A person has shares in her hand and places an order with the broker to sell the shares. The transaction takes place immediately. Now further steps have to take place, that is, of getting the shares from the investor to the broker and then to the clearing house. Yes, these are digital records, but it takes time and effort to do this processing.

Conversely, a person places an order to buy shares. The transaction takes place immediately. But subsequent steps are required, such as the investor giving money to the broker and then the broker giving money to the clearing house. Yes, money is just bits and bytes, but it takes time and effort to do this processing.

There are some people in India who are fully in the digital nirvana state. They use UPI and bank applications on their mobile phones. They use some electronic/digital broker app on their mobile phones. They are connected to their mobile phones at all times. They are confident and comfortable doing large financial transactions using their mobile phones. We see that for such people, it is indeed feasible to place a buy order, which gets executed within seconds, after which they tap into their phone and pay up the money.

The problem lies in the fact that most people in India, or at least a large number, are not (yet) "digital natives". As a wise former minister of the Government of India once said, "India lives in many centuries at once". Perhaps 5 per cent of India is this "digital native", but 95 per cent is not. We may quibble on the exact percentages, but a large enough India is not yet there.

A lot of people in India are more comfortable living in a world where a phone call is made to the family broker, and an order is placed. Then a phone call comes back to say the order is executed, and an email comes in with the amount of money that has to be paid. They prefer to write a cheque for the required amount and send it to the broker's office. It takes some time for the money to move to the broker's account. Today's digital natives may decry the delays of this world, but much of India is in this mental frame. There are people who might use UPI to pay for a *chai* but would not use UPI when moving large sums of money.

And, of course, there is the problem of foreign investors, who operate in a different time zone, who face frictions and delays in converting foreign exchange into Indian rupees and vice versa. For them, too, more time is required to process the transaction.

What happens when the settlement delay is tightened through regulatory fiat? On paper, it may look like the Indian equity market is remarkable by world standards, doing rapid settlement. But many analog natives may quietly retreat from the market. They may not say anything, they may not appear in a *morcha*, but they will conclude that this market is not for me. A great deal of India sullenly hangs on to real estate and gold in their portfolios.

There should be more to the restaurant industry than Swiggy and Zomato. It is good for India if the widest range of people can directly participate in the equity market. It is good for the equity market when many diverse views are brought into the market: This increases the range of information and forecasts that feed into the price. Broadening the participation will help address the long decline in equity market liquidity over the last 15 years and improve market efficiency. The purpose of policy thinking in financial markets should be on market quality rather than shiny technical features.

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