BIG MARKET REFORMS

Introduction of interoperability marks the beginning of a new era in the history of exchanges in India and is one of the biggest changes in our capital markets in over three decades now

Kunal Sanghavi
Chief Financial Officer (CFO) – Metropolitan Stock Exchange)

The long-pending interoperability framework for clearing corporations prescribed by market regulator SEBI in November 2018, was finally implemented from June 3rd 2019. The first trade in the interoperable environment was successfully conducted on equity cash segment of Metropolitan Stock Exchange (MSE) and settled through Bombay Stock Exchange's (BSE) clearing corporation – ICCL.

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Biggest reforms since the '90s

In the 1990s, the open outcry system to trade in stocks had undergone one of the biggest reforms to pave way for electronic trading, which allowed people to trade from their current locations using computers as against having to be physically present at the outcry market, which was only one at that time. The transition to electronic markets also made the market more robust and transparent.

Now with interoperability in place, it will lead to further democratization of our capital markets. Within the interoperable framework, all players, exchanges and clearing corporations will get a level playing field. As clearing, settlement, trading and, hence, market participation and liquidity gets distributed across all exchanges, it will encourage healthy competition as members would have the option to trade on the exchange of their choice. They also get to choose how they would want to manage their risks by choosing clearing corporation of their choice.

Migrating to an interoperable environment is a remarkable development as it required seamlessly synergies between all the technology systems and processes of all exchanges and clearing corporations. This change required creation of a technology system that was resilient and hi-tech enough to allow all exchanges to identify and report trades to their respective clearing corporations on one side, and do risk management by clearing corporations on the other side, all on a real-time basis.

Benefit to exchange members

In an interoperable environment, members can take the benefit of their margins lying with other stock exchanges on a real-time basis and, therefore, need not wait to deposit margins separately on the exchange where they trade. They also get the benefit of reduced margins for their reverse positions on other stock exchange. This means, margins will be

levied on netted positions across exchanges and not on gross positions. For example, if there were long positions requiring a margin of Rs 1 crore at 10% on exchange A and short positions requiring another Rs 1 crore at 10% of margin in exchange B, then total original margins will be Rs.2 crore. Assuming the above positions are of the same contract in different exchanges, the margin will be on netted position across exchange, leading to almost nil margin in an interoperable environment as against the earlier requirement of Rs 2 crores as margin money. This opens up a huge potential for inter-exchange positions and inter-exchange arbitrage.

More choices for clients and brokers

Earlier, member brokers would have to keep a huge buffer for their funds and collaterals across exchanges and across segments. With interoperability, they will be able to consolidate and reduce this buffer and lower their collateral requirement. Further, they will be able to trade on segments and exchanges where they earlier were reluctant to trade in as collaterals deposited in one exchange's clearing corporation can now be used for trade all across.

Participants will also get more options for clearing and settlement by going for clearing corporation of their choice to forward and settle their trades, irrespective of the exchange where the trade was done. Today exchanges have their subsidiaries as clearing corporations and they mandate all trades on their exchange to be cleared through their own CCL, thus leaving no option for participants.

Effect on clearing corporations

As subsidiaries of stock exchanges, clearing corporations though had been functioning independently so far, but were also sort of captive units where their operations were being driven by the ready business from their own stock exchanges.

In an interoperable environment, clearing corporations will have to function as full-fledged businesses and they'll need to focus not only on operations and risk management but also on servicing every participant, clearing member, etc. and on convincing them to clear their trades through them. In the process, they will have to provide better service to market participants and better integration of technology with other services to ensure greater ease and smoother operations.

Interoperability is the biggest Capital Markets reform since the introduction of electronic exchanges in the 1990s'

Interoperability, in the long run, will thus bring more relevance and independence in the functioning of clearing corporations. It will lead to an increase in the number of clearing members with trading members also becoming clearing members as against today's scenario where the trading members need to tie up with clearing members of different clearing corporations. Clearing corporations, on the other hand, will have larger target audience as they will get customers from a huge pool of market participants.

Impact on risk management

So far, all trades were guaranteed by clearing corporations, which predominantly are like wholly-owned subsidiaries of stock exchanges. Going forward, while risk management will continue to be a function of clearing corporations, but it will happen across clearing corporations for trades on a single exchange, depending on where the market participant has decided to get the trades cleared. This means, trade on one exchange may get cleared through clearing corporation of a competitor exchange and vice versa. This scenario will lead to standardization across all clearing corporations and, therefore, better benchmarking of best practices.

Conclusion:

The interoperability framework prescribed by the market regulator SEBI is a world-class model and is definitely one of the biggest changes that we have seen in our capital markets in many years. Interoperability pushes the Indian exchange industry to the league of world-class exchanges in developed countries like Europe, where interoperability has led to many benefits for all stakeholders.