Future of Depositories as an Integrated Financial Products Platform

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Although India had a vibrant capital market which is over a century old, the paper-based settlement of trades caused numerous problems for investors such as bad delivery, delayed transfer of title, risk of loss of certificates and delivery of forged certificates. The passing of the Depositories Act, 1996 paved the way for establishment of depositories in India. It introduced 'Depository' as the main organization where the securities of the investor are held in an electronic form and from where the securities transaction is carried out by a book entry. The depository interacts with its clients through a 'Depository Participant' (DP) with whom the investor is required to maintain a demat account.

In the depository system, securities are held in depository accounts, which are similar to holding funds in bank accounts. Transfer of ownership of securities is done through simple account transfers. This method does away with all the risks and hassles normally associated with paperwork. Consequently, the cost of transacting in a depository environment is considerably lower as compared to transacting in certificates especially as cost associated with stamp duty and postal charges are done away with.

The depositories have aimed to ensuring the safety and soundness of Indian capital market by developing settlement solutions that increase efficiency, minimise risk and reduce costs. The Indian securities infrastructure has developed rapidly throughout the last decade. The introduction of the depositories has accelerated the development of securities market infrastructures into increasingly integrated and consolidated market structures. In response to market competition and the diversification of financial products, depositories have continued to innovate and redefine themselves, with the admission of wider range of securities and development of other businesses and strengthening the concept of business continuity planning in order to offer the market more convenient and effective back-office services. Further, constant improvements in system, security and procedures have made the Depository System safe for investors. In fact the Depository is a Market Infrastructure Intermediary and one of the key players in the financial market. In particular, technological innovations have spurred these fundamental changes, causing less dependency on physical market locations and thereby exposing market participants to an increasingly competitive environment.

Currently the capital markets are regulated by Securities & Exchange Board of India (SEBI), Banks and NBFCs by Reserve Bank of India (RBI), commodity markets by Forward Markets Commission (FMC) and Insurance by Insurance Regulatory Development Authority (IRDA). The depositories are regulated by SEBI and are currently permitted to admit equity shares, debentures, bonds, g-secs, mutual fund units, certificates of deposits, commercial paper, pass through certificates etc. and such other instruments as defined under the SEBI (Depositories and Participants) Regulations, 1996. Investors are currently not permitted to demat fixed deposits, a popular investment avenue.

In this context, the recommendation of the Financial Sector Legislative Reforms Commission (FSLRC) to hold all financial products in electronic form with depositories is a truly path breaking reform. The Draft Indian Financial Code, states that "every person subscribing to financial products, other than securities, must have the option either to receive such financial products in physical form or in de-materialised form with a depository". The definition of financial products includes insurance contracts, deposits, credit arrangements, retirement benefit plans, small savings instruments or "any other instrument" that may be prescribed from time to time. The above recommendation by FSLRC is discreet but it can lead to huge savings and convenience to all asset holders, while enhancing transparency and providing reliable data for policy formation and regulation of markets. The said concept was also included in the interim budget 2014-15 which stated creation of one account for all financial assets of every individual as one of the steps envisaged to deepen the Indian financial markets.

- **Unified Demat a/c – Benefits:** If all financial products are held in a unified demat account, the following advantages are imminent: Investors will not be required to open multiple accounts falling under different jurisdictions. It saves them annual maintenance charges (AMC) that work out to roughly Rs 300 for each product. Thus, if an investor has, say, insurance policies, corporate fixed deposits (FD) and National Pension Scheme (NPS) membership along with securities, he would end up paying Rs 1200 every year under four different jurisdictions – as against Rs 300 plus if they were all held under a single demat account. It translates into

a saving of Rs 1800 crore for two crore investors (who are already now in the depository system) in the form of AMC for four products. In addition, the ease and convenience of viewing one's holdings and execution of transactions is immeasurable.

- As investors' statements of accounts are available with the depository participants (DP), the possibility of his successors not being able to claim the assets against these accounts will be rare.
- In the event of the demise of the investor, the demat account maintained with the DP will furnish all the assets the deceased was holding. It was reported in The Economic Times (dated May 21, 2012) that nearly Rs 1,700 crore of unclaimed deposits lying with banks and an equal sum of matured insurance policies without claimants. Such instances can be minimised with a unified demat account.
- The huge competitive distribution network of the DPs can make the marketing of even new products such as NPS economically viable. One way to ensure the demographic dividend that India today has does not become a liability for its future generations is to bring the country's young workforce under NPS, leveraging the existing nationwide network of 15,000-plus service centers of DPs. It will also hasten the process of financial inclusion.
- The synergies in developing the IT systems and reduced costs through more efficient sharing of infrastructure will be substantial for a unified depository. The benefits of these can be passed on to the customer in the form of lower tariffs.

Leveraging on strengths: Depositories are regulated by the Securities and Exchange Board of India (SEBI), which, over time, has strengthened the framework for mitigating risks and enhancing transparency and accountability. The market regulator has ensured that the depositories are well-capitalised and promoted only by financial institutions of repute and standing. Further, competition between depositories has ensured that the cost of offering depository services in India is among the lowest in the world.

The FSLRC report is now seeking to spread the benefits seen in securities market to other financial products. But since different financial products fall under the jurisdictions of different regulators, including the Reserve Bank of India (RBI), it requires deep understanding and high level of co-ordination among them to have a unified depository system.

It is not clear whether the term "deposits" under the definition of "financial product" in the Draft code covers bank FDs. If the records of FDs of banks are also shared with the depository system for consolidation of account statements, it will certainly lighten the burden of keeping track of FD receipts and their maturity periods.

Road Map: Currently, risk mitigation measures with regard to depositories and DPs are based on marketability and transferability of assets. While products such as deposits, insurance policies and NPS plans are per se non-transferable, the technology/IT systems developed for the same can still ensure compliance with such requirements. The ATM network of banks can be permitted for viewing and transacting all financial products held in DP accounts using the existing smart cards of investors.

There is also the issue of transparency. Many companies have raised deposits from public, but there is no public record available as to how much has been repaid and unpaid and thus the regulators are unable to monitor compliance. Some have even resorted to private placement of debentures. If it is made mandatory to hold such assets in demat, an easy MIS can be generated for effective policy formulation. Moreover, offenders such as Sharada can be brought to book before matters snowball into intractable situations. The implementation of the FSLRC's recommendation pertaining to the role of depositories may not require a complete overhaul of the existing legislative framework. The Depositories Act, 1996 merely states that securities as defined by the SEBI are to be only held in a demat account. SEBI, as is expected, has defined securities in SEBI (Depository & Depository Participant) Regulation, 1996 to cover only those products regulated by it, such as shares, debentures, units of mutual funds, etc. with freedom to notify any other security at any time.

Further, SEBI regulation 7C prohibits depositories from carrying on any other activity unless it is incidental to depository activity.

Thus, to implement the proposed FSLRC reforms these two amendments could be carried out in the SEBI regulations to operationalise the unified depository system – and other financial sector regulators could accept (both in letter and spirit) the jurisdiction of SEBI over the unified depository services framework, including the role of depositories and DPs for dealing in other financial products. Alternatively each regulator can recognise the depository as the central record keeping agency and permit them to hold the products regulated by them. This will bring in a sea change in the way financial sector operations pan out in the country.

We will not be surprised to see, in the near future, the holders of other class of assets (moveable or immovable) also join the chorus for their ownership record being kept in electronic form.