Universalisation of institutions in India's Securities Market: Some Perspectives

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In the development paradigm of India, access to financial products is a necessity. In order to achieve this objective, the role of institutions for intermediation has been recognized by the Government, and efforts made to touch the untouched and reach the unreached in outlying parts of the country.

One of the measures to achieve this objective was the idea of 'Universal Bank', mooted in India in the 1990s. At least two government-appointed committees (Narasimham Committee and Khan Committee – both in 1998) had recommended setting up of universal banks in India through integration of financial activities. The proximate advantages attributed to a universal bank was better resource utilisation through economies of scale, which could result in better customer service by such a 'One-stop shop'. However, the proof of the pudding lies in eating it. Doing away with Development Financial Institution, without the development of a vibrant long-term debt (read bond) market has led to an asset-liability mismatch and the country is struggling to find a solution to it.

To reap the benefits that could accrue from integration of market segments and the institutions that serve them, the idea of Universal Exchanges was mooted in the Budget Speech of the Finance Minister in 2017. According to this announcement, commodities and securities markets would be integrated by integrating participants, brokers and operational frameworks. The merger of the Forward Markets Commission (the regulator of the commodity derivatives market till September 2015), with the Securities and Exchange Board of India (SEBI) effected from 28 September 2015, prepared the ground for this. The commodity derivatives market was moved under the regulatory purview of SEBI, which had an enviable record of investor protection, that could be ranked at par with the best in the world[1]. Concurrently, consequent to amendments in the legal framework, Commodity derivatives were now treated as 'securities'. In the months following the merger, SEBI undertook a number of measures to strengthen the risk management system in the market intermediary institutions. This paved the way for expansion of the market through introduction of new participants and products. With commodity derivatives now being legally classified as 'securities', new instruments like Options and derivatives on Intangibles, became possible for introduction in this market.

The merger of the regulatory body supervising the commodity derivatives market and alignment of the legal framework of the commodity derivatives, laid the foundation of a slew of positive developments in the securities market. SEBI allowed entities under its own regulation like Mutual Funds, Alternative Investment Funds and Portfolio Managers to participate in the commodities market. The Reserve Bank of India permitted banks to become clearing members of SEBI regulated clearing houses and allowed bank-sponsored broking houses to distribute financial products in a new market, under direct supervision of SEBI. As a consequence, most major banks are at various stages of becoming Professional Clearing Members of commodity exchanges, while the prominent bank-owned broking houses have become or are in the process of becoming trading members, thereby incentivising their clients to participate in the commodity derivatives market.

After the merger of the regulatory institutions, the next logical step for deepening the commodity derivatives market, was to remove the artificial barriers that segregated the institutions distributing commodity derivatives among the public viz. the broking firms. Till 13 July 2017, a stock broker or clearing member carrying on broking activity in securities could not undertake the activity in commodity derivatives, and vice versa. With the amendment of the regulations, post that date, a single entity could act as stock broker/clearing member in commodity derivative markets as well as in the equity markets, thereby eliminating setting up a separate entity. Given the commonalities in the intermediation services between the two markets, removal of this artificial segregation paved the way for significant cost saving for brokers, thereby enabling them to reap economies of scale. No longer were they required to maintain separate networth for the different segments they serve. They could now adjust profit or loss in one segment against the profit and loss of another segment and enjoy the benefit of margin fungibility and pass on the same to their clients.

The unification of equity and commodity segments, aims to considerably reduce the compliance costs of brokers and their clients, by measures such as easing of KYC requirements, and maintenance of single accounts. It may be mentioned that prior to unification of broking services, one of the objectives of SEBI inspections of stock brokers, was to check possible movement of funds between securities and commodities markets in the records of the broker, since it was prohibited under the extant regulations, on the premise that exposure of securities market to the risks of the commodities market was unacceptable and hence prohibited.

The policy of a unified license for commodity and equity broking, therefore, incentivised broking firms to channelize their financial, human and other strategic resources for expanding the market, and in particular, their base of new retail customers. The introduction of bank-owned broking entities at this juncture provided a multiplier effect, to these efforts with growth in retail clients. To illustrate, in case of MCX, the growth in retail clients during 2018-19, particularly in the second half of the year, was more from member-brokers who had merged their equity and commodity broking arms, vis a vis other member-brokers.

After the unification of the regulatory bodies, the legal-regulatory framework and intermediation service providers among the different segments of India's securities market, the next policy action was to integrate the platforms where products from different segments were traded. From 1 October 2018, all recognized stock exchanges[2] have been permitted to offer all types of security contracts for trade, cutting across market segments (equity, commodity, debt or currency), subject to regulatory approval. Thus, Universal Exchanges were born. The advent of universal exchanges has also heralded an era of competition, leading to innovation and differentiation in products and services by Exchanges. For instance, to differentiate from a successfully-run monthly cotton contract available on an exchange for 10 months, another exchange launched a similar contract for 12 months. Similarly, exchanges that have offered commodity futures since 1 October 2018, have provided access to the market participants at zero transaction charges. Such differentiations could potentially be geared towards providing greater service to customers, especially retail players, as also penetrating hitherto excluded geographies and population groups.

So far, the platforms specializing in equity products have evinced interest in offering commodity derivatives on their platforms, by launching futures contracts in a few commodities. Going ahead, one could witness exchanges specializing in commodity derivatives too to offer securities in other segments like currency, debt or equity, to their customers. After all, the SEBI-prescribed criteria for stock exchanges, viz. risk management systems, financial soundness, grievance redressal mechanism, separation of trading and clearing, etc. are now prevalent in all exchanges – regardless of which segment they specialise in.

India's commodity derivatives markets are undergoing rapid transformation, catalysed by policy and regulatory reforms aimed at deepening and broadening the market for making them more useful to all stakeholders, especially the small participants. The universalisation of the institutions that operate in the broader securities market is work in progress. Going ahead, one may witness the benefit of interoperability among clearing corporations (already introduced in the equity market) to the commodity derivatives market too. Such interoperability can yield benefits to member brokers and their end-clients, since this would obviate the need for brokers to maintain margins at multiple clearing corporations, while separating the execution risk from settlement risk in case of a technical or event-based trading glitch.

The process of universalizing institutions in the market and harmonizing trade processes and practices across market segments has only begun. The flow of resultant benefit may take time to gather momentum, but once this happens, the commodity markets can look forward to move in the direction achieved by the leaders in this field, such as Chicago Mercantile Exchange Group, London Metal Exchange, Inter Continental Exchange.

1 World Bank's 'Ease of Doing Business' Report 2017 places SEBI at 4th position among securities market regulators worldwide in terms of protection of minority investors

2 the Securities Contracts (Regulation) Act, 1956, or SCRA, which provides the overarching regulatory framework for the Indian securities market, which includes commodity derivatives, refers all regulated exchange platforms as 'recognized stock exchanges'