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Hong Kong is in a special position among leading stock exchanges. It already has in place arrangements for very prompt settlement for transactions. The advantages of this situation are worth spelling out, all the more so, since some much larger exchanges have long operated on the basis of more generous settlement periods.

The major benefits of a minimal settlement period are its efficiency in reducing exposure to market risk and enhancing liquidity. In principle, equity markets should have the shortest possible settlement periods so that buyers take delivery and sellers receive payment promptly and with maximum certainty. This principle is neatly set out in the Report of the FIBV Task Force on International Settlement:

> "The objective is to reduce to the minimum the period of time between trade execution and settlement. The shorter the period, the greater is the reduction of all elements of risk. Settlement on the day of trade execution would therefore be a major goal, with perhaps on-line settlement the ultimate objective. As an essential intermediate goal the Group of Thirty's recommendation of a T+3 arrangement by 1992 is fully supported, except where a particular market already settles, or could settle, in a shorter period."

Hong Kong has traditionally adopted a 24-hour settlement rule. The existing system for share settlement in Hong Kong requires physical

delivery between brokers. The massive movements of paper involve cumbersome procedures.

An additional complication confronts investors after settlement if they want immediately to secure the benefits and exercise the rights attached to the shares. The re-registration process takes up to 21 days before new shares are available. Our 24-hour settlement rule and the legal restrictions on short selling and stock lending effectively prohibit the sale of shares pending registration.

As a result, most shares are held in street names outside of books-close periods. They, thus, become, in effect, bearer shares, with registration highly concentrated immediately prior to the record date for dividends or rights. This system lacks security. It is prone to severe strain in times of high market activity.

In addition, as in other markets, the existing settlement system is widely perceived as a hindrance to the dealing system which has the capacity to cope with much higher volumes. The October 1987 experience emphasized these defects, although the need for a central clearing and settlement system was recognised well before that date.

The unification of the four stock exchanges, together with the introduction of computer-assisted dealing in 1986, resulted in a substantial increase in both trading volumes and in the level of international participation. The bull market of 1986-87 demonstrated that it can become almost impossible, for all trades to comply with the traditional 24-hour rule, even for transactions in which all the participants are local. Admittedly the 24-hour rule had not been rigidly implemented. The situation is of course not satisfactory.

However, choosing an ideal period which is of course longer is a complex business. Apart from anything else, we have to note that the more efficient operators - those participants able to settle comfortably under the current 24-hour rule - will be asked to accept a doubling (or more) of that period and a consequently greater market risk.

Thus, the Stock Exchange has been able to reach agreement in the spirit of compromise among almost all of its members to extend

the settlement period to T+2. It is indeed a major achievement. Current statistics show that about 75% of trades are settled consistently on T+1, i.e. within the current rule. Thus, the majority of brokers and investors are geared to T+1. Frankly, our decision to extend the settlement period to T+2 could be seen as a step backward in the sense that it penalises the efficient majority of brokers.

So why did we agree to reverse directions? In an economy which prides itself upon being open and international, our instinct was not to just take a local view of the ideal settlement period, even though a very strong case could be argued for not shifting from T+1 to T+2. We also had to take fully into account the international investor and the impact of time zones on his settlement. For instance, we modelled a complex settlement case involving a fund manager in Sydney, an underlying beneficiary in New York, a global custodian in London and a sub-custodian in Hong Kong. Even in these worst-case circumstances, we are satisfied that settlement can normally be completed within T+2, assuming reasonably efficient and accurate processing.

As you would expect, we have lengthy and often spirited debates on this issue. Fortunately, we have found enough mutual goodwill to agree on a compromise. It is of course recognised that there are points of detail which are in the course of being addressed. The current position is that supporters of T+1 and advocates of T+3 or longer have agreed to T+2 which will be implemented after the systems of stock borrowing and lending and central clearing and settlement are satisfactorily in place. The implementation would be in the second half of 1991. A review of the T+2 system will then take place in six months' time.

In these circumstances, an obviously urgent priority has been to get in place a settlement system that would enable all participants to reduce the average time needed for settlement to a minimum. This goal was not a new one, of course. Provision of a central clearing system is an object of the Exchange, under its Memorandum of Association. But immediately after the creation of the unified Exchange,

the first priority had to be the evolution of an integrated, smoothly-operating unified market in place of the four exchanges which had existed previously. At the same time, a computerised dealing system had to be put in place. These urgent tasks, inevitably, absorbed the bulk of the financial and managerial resources available.

The crisis created by October 1987 altered priorities dramatically. Settlement problems were brought out from back offices and became news headlines. The need for a central clearing system became overwhelming.

The initial response was the Clearing Project, organised under the Exchange's interim Management Committee and guided by Mr Robert Fell, who you all know is a member of the G30 Steering Committee on Clearance and Settlement. Although funded and, initially, staffed by the Exchange, the Clearing Project was a separate entity supported by all the major market participants. This arrangement had the added benefit of ensuring full participation by all interested parties and was supported by a series of consultative working parties composed of brokers, custodians and registrars. By May 1989, the process had progressed sufficiently in identifying both the problems involved in the system and their solution, for work to begin on putting together a new system.

The work was taken up by the Hong Kong Securities Clearing Company Limited (HKSCC) formed on May 5, 1989 as a not-for-profit organisation limited by guarantee. Continuing the arrangements of the Clearing Project, the Exchange provided the funding and is responsible for 50% of the guarantee with the remaining 50% being shared equally by five of our premier banking institutions: the Bank of China, the Bank of East Asia, the Hang Seng Bank, the Hongkong and Shanghai Banking Corporation and the Standard Chartered Bank. The Board also reflected the consultative stance of the Project, being composed of 14 members, five from the Exchange, one from each of the bank shareholders, together with a representative each from the custodians and the registrars and the Chief Executive of the Exchange and HKSCC as ex-officio members.

For the long run, we believe the new settlement system will eliminate the time factor. By the third quarter of 1991, we expect to have up and running a central clearing and settlement system based on two concepts: centralised broker-to-broker net settlement; and book-entry delivery and transfer of uncertificated shareholdings. Existing trading practices will not be affected. Trading data will be transferred by the Exchange to the HKSCC for processing after close of the market on trade day. Electronic links will connect up all participants. Money transfers will be through the established banking system. HKSCC will guarantee all trades in Hong Kong stocks on the Exchange locked into the system at the time of trade data transfer.

Out of the nine recommendations made by G30, Hong Kong will be able to comply with seven in full and one in a slightly modified form, i.e. T+2 instead of a T+3 rolling settlement period. The only recommendation that will not be considered at this stage is the second, because, initially, HKSCC will admit only brokers and custodians as members. All indirect market participants including professional investors will settle through brokers and custodians. It is hoped that the private sector will offer a trade comparison facility to indirect market participants, or at least to institutional clients, by some time in 1992.

Hong Kong is, therefore, in a unique situation. Whilst other exchanges are attempting to compress their existing settlement periods to reduce market risk, Hong Kong proposes rationalising its settlement rules by an extension of the settlement period.

We note that it is not explicit in the G30 recommendations whether T+3 by 1992 is a final goal or is itself an interim step to a shorter period or even on-line settlement. For us, it is an article of faith that the shorter the settlement period the better. Thus, we in Hong Kong see ourselves as running ahead of, rather than against the rest of the field. We are confident that our own efforts to achieve minimal settlement periods, even when faced with drastic institutional reorganisation and very volatile market conditions, are a demonstration of the way in which short settlement periods are a realisable goal, useful indicators of market efficiency and a valuable safeguard for participants.