Indian Securities Market - Challenges Ahead

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The securities market in India has evolved over the years to set various global benchmarks and best practices, be it in the wide range of products on offer or the mechanism employed to smoothen the trade flow. The market has the benefit of holding major position in several areas of operation.

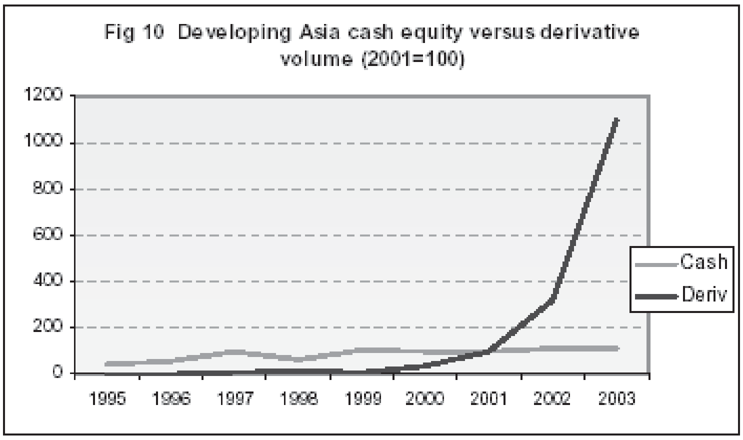
It enjoys the distinction of being one of two world markets to have introduced T+2 settlement cycle, the other being Taiwan. Further, it has created a separate platform for the mid and small cap companies- Indonext, so as to increase trading activity in these segments.

standing

Its standing in the global scenario increased substantially when it effectively demonstrated its surveillance and risk management strength. On May 17, 2004 the Indian markets crashed 20% in a single day however no defaults on part of the members/brokers was experienced and market activity continued the following day normally.

Additionally it has proved that it can adopt the international practices with the computing of its indices on free float methodology so as to induce companies to increase their equity float. The Indian securities markets lead in technology (trading platforms, nationwide networking, straight through processing, digital certification), dematerialization and managing a large number of listings.

On the trading activity front, the go ahead to commence derivatives segment four year ago has changed the Indian markets forever. Developing Asian markets as a whole have experienced a rapid rise in derivative volumes, considerably outstripping equity market turnover growth and this growth remains narrowly based in the Indian, Taiwanese and Korean markets. India has been particularly successful with stock futures contracts.



India's gain in market capitalization ranges from remarkable to record breaking. Its share in market cap of the lower and middle income countries shot up from 10.3 per cent to 19 per cent during 1990-2003. In 1990, India's market cap was just about 1.26 per cent of the US and 4.5 per cent of the U.K and 35 percent of Korea which in 2004 rose to 3 percent, 14 percent, and 97 per cent respectively. In 1995 it was 24 per cent less that the top 20th ranked nation (Korea) by marketcap where as in 2004, India is ranked 17th.

There however persist various aspects of market infrastructure that call for attention of all market participants be it the regulator, the exchanges, the brokers, the institutional investors, or companies that tap the equity markets. Confidence of the people in the markets and the exchanges is of utmost importance to provide a healthy vibrant market for investors. Building such a confidence over a period of time is a steady requirement, which is usually rocked during bull runs in the markets. Keeping and further building this confidence is thus an important challenge to all market participants like the regulator, the stock exchanges, the brokers and the financial institutions. There is also much scope for expansion of markets and range of products provided.

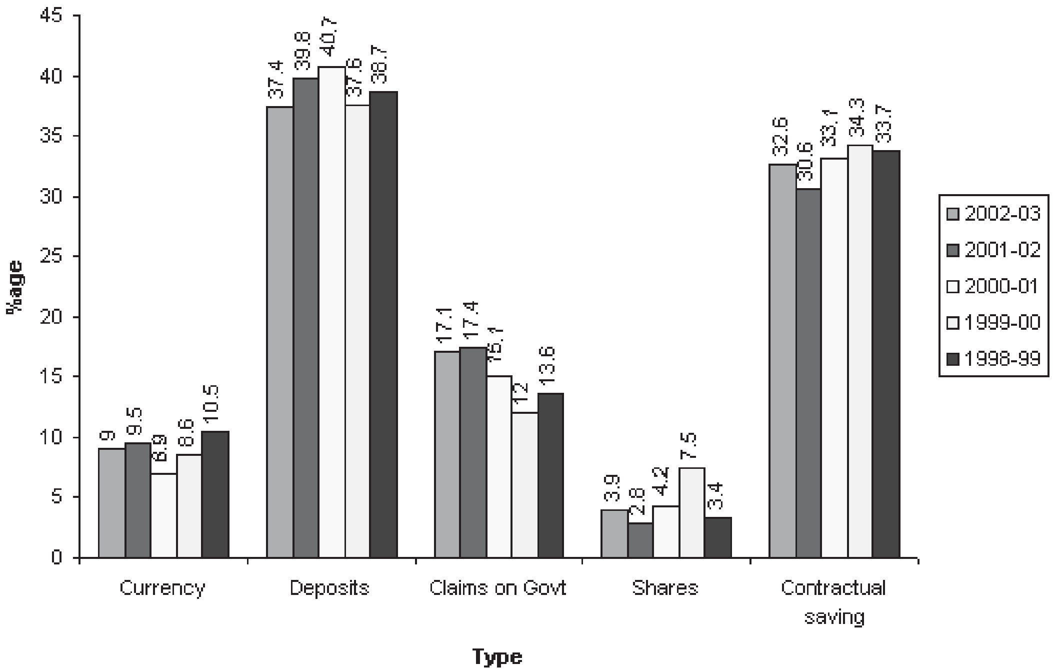
Issues to that need to be dealt with include

Depth
Market concentration & number of companies traded
Investors
Demutualisation
Delisting/corp governance/cost of public equity
Integration of the financial markets

DEPTH

Securities markets in developed as well as emerging economies have a significant share in the financial system as a whole, including banking, insurance, mutual funds etc. In India this aspect of market development has to be carefully looked into. There has to be a concentrated effort to increase the depth of the market so as to have a credible alternative avenue to raise resources, increase wealth and savings.

Household Savings (% of Financial Assets)



Only a meager four per cent of the household savings go into shares (inclusive of mutual funds) while an enormous portion of it goes to deposits and contractual savings (insurance and pension schemes) accounting for close to 70 % of the savings. While India saw a shift towards the capital markets in 1999-2000 during the tech boom, soon after the crash the share has substantially gone down. Retail investors that is around 25 million is just a fraction of the active population and have been investing a only a marginal portion of their financial assets into the markets. Although their investments rose in the tech boom of 1999-00 and 2000-01 to around Rs 16000 and Rs 11000 crore respectively this has since then declined to Rs 7554 crore in 2003-04. It’s imperative to channelise the flow of the household savings into the capital markets. A small step has been taken recently in the Union Budget 2005-06 with retail investors allowed to invest upto Rs 1 lakh of their tax planning savings into mutual funds. Further efforts should be made to increase the breadth of the products on offer to investors so as to provide a broader scope of investment avenues in the securities market.

The percentage of financial assets of the household sector that go into shares and debtentures has been on a gradual decline since the early 1990s falling from 10 per cent to the present 3 per cent as per latest statistics available with the RBI for 2002-03. Retail investors have continuously reposed their savings in bank deposits and in the LIC and pension fund schemes. In value terms this equals to Rs 7554 crore in shares in 2003-04 as against Rs 178839 crore held as bank deposits and Rs 62206 crore with the LIC. In 2003-04 the household sector invested 14 per cent of its financial savings in small savings, 15 per cent in insurance funds, 13 per cent in provident and pension funds, a whopping 43 per cent as deposits and only 1.4% with shares of which mutual funds other than UTI garnered a major chunck. This has been the general trend for the past couple of years.

No of Investors to population

Malaysia	5.32
China	2.86
Taiwan (all investors)	33.38
Korea	8.14
India	2.35

Investor Participation

The Indian securities market is retail driven with institutional investors accounting for around 25% of the turnover. This is one of the reasons for the volatility of the markets, which in turn scare's the retail investors off. Banks are allowed to invest only about five per cent of their outstanding advances at the end of the previous financial year into the capital markets. Its been found that although private sector banks come close to reaching this limit and also occasionally breach this limit, public sector banks are as yet shy of the markets preferring the G Secs (means of financing the government therefore a part of domestic finance) as way of investing their resources.

Further, there is a cap of 35 per cent on the total investments that can be made in the capital markets per year from the usual insurance scheme. Unit based equity linked insurance schemes are allowed to invest 100 per cent of their funds into the capital markets. Allowing pension and provident funds to participate in the markets has been embroiled in controversy.

Market Concentration

The Indian stock markets show the greatest concentration levels among the world stock exchanges. This has to a large extent been corrected and over the last five years the percentage share of the top 5 securities has halfed from a high of 50% to 25% of market turnover. Further although the correction is not to that large an extent for top 200 companies its been got down 15% in the same period. While earlier almost all the turnover at BSE was accounted for these 200 companies now its down to 85%. With India having the largest number of companies listed it becomes imperative to further broad base the scope of trade. Very little information is available to investors on a large number of companies listed that constitute the small cap segment making investment in these companies difficult. With a possible increase in adequate data and research on those companies which have potential and comply with exchange/regulator guidelines trading activity on could be enhanced. Independent research by unbiased intermediaries will lend authority to the research report and build confidence in the company.

Percentage Share of Top 'N' Securities in Turnover of BSE

	No. of Securities					
No of Securities	**5**	**10**	**25**	**50**	**100**	**200**
2000-01	50.37	70.76	88.15	94.45	97.76	99.27
2001-02	40.82	56.96	78.51	90.28	95.73	98.46
2002-03	37.73	53.28	74.41	86.25	93.31	97.20
2003-04	30.75	43.55	60.89	85.94	85.94	93.23
2004-05	25.42	39.04	52.53	64.12	75.24	85.13

5% MOST CAPITALIZED AND MOST TRADED DOMESTIC COMPANIES

	2004		
Exchange	5% market Value	5% trading Value	Number of Companies
Buenos Aires SE	64.3%	68.6%	5
NYSE	55.8%	37.8%	92
Sao Paulo SE	62.0%	61.3%	19
Euronext	68.8%	62.3%	50
Istanbul SE	63.2%	49.8%	15
JSE South Africa	53.8%	85.3%	19
London SE	82.2%	84.3%	124

Tel Aviv SE	65.5%	67.0%	29
Warsaw SE	67.4%	67.1%	11
BSE, The SE Mumbai	89.2%	91.1%	235
Bursa Malaysia	64.8%	40.7%	48
Colombo SE	45.8%	47.9%	12
Hong Kong Exchanges	78.6%	73.0%	54
Jakarta SE	68.4%	66.7%	17
Korea Exchange	74.5%	60.1%	34
Shanghai SE	46.0%	30.8%	42
Singapore Exchange	68.3%	65.5%	30
Taiwan SE Corp.	60.6%	41.0%	35
Thailand SE	61.5%	47.2%	23
Tokyo SE	56.9%	59.2%	114

Note : Market concentration of 5% of the largest companies by market capitalization compared with total domestic market capitalization and trading value

Further, there has been an improvement in terms of the number of stocks traded. Considerably more companies are now trading for more than 100 days.

Trading Frequency of Listed Stocks

Trading Frequency (Range of Days)	No of Companies Traded	
	2003-04	2004-05
Above 100	2120	2368
91-100	41	36
81-90	35	37
71-80	36	35
61-70	35	32
51-60	57	50
41-50	53	34
31-40	59	41
21-30	61	68
11-20	95	63
1-10	235	142

Demutualisation

Global trends show a shift in the governance patterns of stock exchange. Increasing number of these institutions are moving towards becoming a demutualised and corporatised company. In keeping with global moves, BSE has become the first stock exchange in India to undertake demutualisation process and its corporatisation plan will be used as a model for other regional stock exchanges to follow suit.

Demutualisation and corporatisation entail great challenges to the stock exchanges. While it enables the exchanges to expand the realm of business and activities at the same time it will enforce corporate governance norms as well as taxaction and other compliance related aspects which envisages high degree of professionalism and transparency in conduction operations and charting growth process.

Delisting/Cost of public equity/corporate governance norms

Norms for corporates and senior management compliance are becoming more stringent with regards number of disclosures. With compliance and regulation of the numerous corporates listed on the exchanges becoming increasingly demanding and taxing the cost of public equity has been steadily increasing pushing many of these corporates to weigh the pros and cons of listing. Many have found it beneficial to delist. This poses a challenge to exchanges and regulators alike by way of a need for maintaining a fine balance between effective monitoring of those companies, which are lax in compliance and excessive regulation.

Integration of financial markets

India has moved from T+5 settlement period to T+2 period relatively smoothly. This has largely been due the integration of the various constituents of the financial markets including the banking system, depositories, exchanges, regulators. The recent launch of RTGS in major banks has already been much appreciated in the markets. The great need for operational integration of these institutions need hardly be emphasized more. Close working and timely execution of the whole trading experience for the investor will go a long way in increasing trading volumes.

Looking Ahead

The challenges for Indian securities markets in the years to come would be (a) pursuing integrated surveillance and risk management that balances and manages risk across exchanges, segments and products (b) adopting international best practices in a smooth and sustained manner (c) exploring business opportunities in international markets by way of providing greater access to international investors to invest in India as also enable Indian investors to look for good opportunities in the international markets (d) promote greater education and awareness among the market participants and investors (e) continue to design and deliver innovative and cost effective products and services (f) benchmark operational processes and accordingly evolve technology options and management systems (g) and above all to continuously work for the protection of investor interests and create conducive conditions for continued wealth creation.