Stock exchanges can lead financial inclusion

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Financial inclusion is only one part, but an important one, of inclusive growth. India started looking seriously at financial inclusion only three years ago, with the RBI guidelines on no-frills bank accounts. But financial inclusion has to go beyond this. In fact, that is only a starting point; inclusion is more about access to financial instruments. Policies that are technology driven, and which provide for fair and greater competition, can be the only answer.

While we can adopt/adapt international models, we have to develop and implement "local" thinking. We have proved that domestic entrepreneurs with totally Indianized mindsets have delivered a far greater value to the economy. We need a "Bharat Model" and we need to find a key to that model, soon. Fortunately, every thing is in place, or could be easily put in place. The problem is that there continues to be a serious lack of will. We all have a sense that we should do it, but we only keep talking about it.

This article focuses on financial inclusion through the capital market route, and more specifically the role of stock exchanges in this monumental task.

Stock exchanges-The pivot for growth

A stock exchange typically is an entity that provides a centralized forum for stock trade. Additionally, it facilitates information production and dissemination. But exchanges perform an even more fundamental, and an important, role. They are a platform enabling companies to raise capital and on the other, an agent to mobilize and channelize household savings into the capital market. According to the RBI, less than 5% of Indian household savings get invested in the capital market. More than half of it resides in low-yielding bank deposits and these have to be increasingly moved into the capital market, for the growth of the economy. Exchanges also provide a perfect and non-controversial route for government to undertake disinvestments.

It needs no emphasis that the development of robust capital markets is paramount not only to the growth of the country but also for the survival of commercial enterprises, and that exchanges are the pivot for this.

Historical perspective

From just BSE operating as a monopoly for decades, India saw the birth of several regional exchanges, one after other, mainly after the Independence, to allow more investors to participate in the capital market as also bring about growth of the economy across all regions of the country by facilitating companies to raise money and list at a proximate exchange.

Despite the setting up of more than 20 regional exchanges, BSE continued to enjoy a near-monopoly status. The Indian exchanges had been operating as a mutual association of brokers, generating conflict of interest. The setting up of the demutualized NSE in mid-90s was initially seen as a small effort. But the subsequent years have seen a complete overhaul of this industry… growing dominance of NSE, near-marginalization of BSE, and closing down of all the regional exchanges. Subsequently, under Government directions, BSE became a demutualized and corporatized entity in August 2005, with some regional exchanges following thereafter. Having undergone a swift evolution, the demutualized and electronic entities have overcome structural inefficiencies, and have now attracted high strategic valuations from global players.

Challenges ahead…

The last 15 years have been a watershed for the Indian capital market, led from the front by the exchanges bringing, among several measures, electronic trading and transparency. This has, for example, led to the daily turnover going up from a few hundred crore to over one lakh crore. However, the capital market is still touching the lives of a very few.

Penetration of the capital market on a scale similar to what has been achieved in the telecom and banking sectors is warranted. This is achievable as we have world-class regulators, technology, clearing, settlement and depository systems. The need is for the exchanges to take up a more aggressive, creative and greater role. The global benchmark of value traded to GDP substantiates under-penetration of equity markets in India. The global average of value traded to GDP for the cash segment stands at 177%, while NSE, India's largest exchange, has a value traded to GDP ratio of 64%.

More investors :Of an estimated 17.7 per cent of the total Indian households surveyed by SEBI and NCAER, only about 1.3 per cent invests in equity shares, bonds, and debentures. Today, there are only 15 million demat accounts (the maximum number that is in the capital market) .This represents only about 1-1.5% of the population. Of these, less than 6 lakh investors are active on any given day, representing under 0.06 % of the population.

Our target should be 100 million customers in next 5 years.

More geographical reach : In spite of long history and maturity of the Indian stock markets, the geographical penetration level remains low. The current pattern suggests that trading is largely concentrated in big cities. More than 90% of exchange trade is confined to only 10 cities. This is leading to increasing economic disparity between the urban and semi urban areas. Such concentration only defeats the goal of financial inclusion.

The penetration of the capital markets should increase from a mere 1500 cities/towns to at least 5000.

More listings : The decision variables of firms are the costs in terms of listing fees, and liquid markets, with more investors and intermediaries, where they can raise capital cheaply, and build their reputation. As such, when exchanges provide listing, they should also provide other valuable services.

Indian exchanges, who have traditionally received listings on a platter, shall now have to become marketing-oriented. Competition would lead to such marketing orientation. International exchanges like NYSE, NASDAQ, LSE and SGX, with local offices or frequent visits, have for over a decade been undertaking aggressive marketing to get Indian companies listed with them. Such efforts, aimed both at domestic as well as international companies, have been lacking here. A case in point is the Indian Depository Receipts. Five years after its legislation, not one IDR has listed in India. Though there have been some regulatory issues, it also has to do with the lack of hunger at the exchanges for more listings.

On the other hand, though it has been on the discussion board for long, time has come to urgently establish SME-dedicated exchanges. SMEs abound in India, and need a capital raising platform. Exchanges also have to demonstrate aggression in the government disinvestment programme.

More listings would mean more capital raising, more depth to the market, more investors and surely more transparency and discipline in the hitherto unlisted companies.

More products : One area we are lagging behind is product innovation. Delta trading does not contribute to capital formation. In the last five years, barring equity derivatives products and recently the currency futures, no major product launch has taken place.

Huge scope exists for the development of options markets, warrants markets, exchange traded funds, clearing functions for investors investing abroad, opening of trading terminal outside India, IDRs etc. For true financial inclusion, products for masses across multi asset classes would need to be made available across the country

Exchanges should also use their technology platform and reach to distribute other capital market products like mutual funds and IPOs.

Lower costs :Huge economies of scale have led to lowering of costs on almost all fronts. India can boast as one of the most cost-efficient countries. Technology has been the main driver. In some areas, it has also come about because of competition, like in the depositories.

There is still a need to achieve greater efficiencies and offer lower entry and transaction costs to the investors.

More and better information : Investors prefer markets that have a greater flow of information, thus, where price risk is smaller. Exchanges shall soon have to stop acting as mere post offices of corporate information.

The exchanges would not only need to validate such information but also make it more usable, and also seek and provide more information to the investors.

More regulation :Since exchanges execute SEBI regulations, they work as a second line of defense. Till a few years ago, exchanges were regularly embroiled in scams. Though there has been a great improvement, the regulation is still light. This is partly because of the overlap with the regulators and partly because of the conflict of interest. Taking action against companies that provide listing and trading fees obviously becomes difficult, especially after exchanges have become for-profit entities. Little wonder, the UK, for example, took away the regulatory function of the LSE once it was listed, and transferred the same to the UK Listing Authority.

Exchanges have to demonstrate a strong protection for minority shareholders. There is merit in re-looking at the proposition of rejuvenating the Central Listing Authority.

How will this be achieved?

Ever since liberalization, started in the early 90s, the biggest beneficiary has been the customer, with better services at a lower cost. Today there are nearly 100 banks, over 25 insurance companies and tens of telecom companies providing the best of services, at par or even better than international standards, to a huge 300 million customers. A single private company has provided mobile phone connections to no less than 10 crore customers across India. Its call charges are perhaps the lowest in the world. It is not a monopoly as it has four strong competitors. As a result, tele-density has increased from 13 per cent in March 2006 to 37 per cent in March 2009. Over a crore new connections are being added every month. The telecom revolution has really reached the common man.

The Indian capital market should grow because of demographic change, the establishment of pension funds, and the privatization of large state-owned companies. Clearly, one more paradigm change is needed. We cannot rest with a percent growth, year on year. The time has come to move into the new orbit. This can be achieved through a greater role of the incumbents as well as by creation of more entities, more competition. Competition is an incentive to reform.

Are more exchanges the answer?

Globally, during the last two decades, major changes have affected the exchanges. These had long been seen as philanthropic institutions organized to act in the public interest, but have now moved from an era of monopolies to a new era marked by competition, led by private markets. Market globalization and technological developments are causing this phenomenon to be felt worldwide, as the once traditional structures of monopolies are being destroyed. Exchanges are undergoing organizational and operational changes. Competition has encouraged new structures and adoption of better technology, and this has been beneficial for investors and firms.

Some may argue that India can do with two exchanges and that any additional exchange will only fragment the market. There can be no debate on this. Monopolies can lead to complacency. Duopoly is as bad. History has shown that good competition actually expands the market. This is what NSE was able to achieve, and significantly, courtesy a totally new approach to exchange management and a sound corporate structure imparting execution efficiency, The industry has migrated from 23 exchanges to a two-player market, with NSE having a 90%+ market share and a near 99% share of the F&O segment.

More national-level exchanges will only further enlarge the market size. In a free market, competition is exemplified by the presence of new entrants who try to take advantage of market gaps. Market-driven fragmentation and the diversity of trading mechanisms are desirable. There should be no scope for protectionism.

On one hand, NSE, the present undisputed leader, shall continue to innovate and deliver better solutions to maintain its growth. On the other, BSE, which has finally found a leader after nearly a year now, is gearing up to reinvent itself. There is today a challenge for BSE to regain its lost ground, which does not necessarily mean taking away the existing business of NSE, but reaching out to new customers and rolling out new products. BSE is also tying up with other exchanges to expand its reach. Some of the regional exchanges, notably Delhi and Kolkata, are working hard to create a space for themselves. The MCX stable, which has already made successful forays in commodities and exchange futures, is waiting in the wings to start operations in the capital market segment.

Entry of new players should be facilitated. Competition in fact needs to be encouraged in all spheres of the capital market: exchanges, brokers, institutions and products to derive the true benefits. As long as new entities meet the eligibility norms, the regulators should support new entrants. There is after all no government support or public funding at stake. Exchange is a business, and the entities be allowed to take a business risk. The important thing is to ensure that the new entities are adequately and uniformly regulated.

Indian stock markets have to reach their full potential through full range of products and multiple methods of accessibility including mobile. While advances in telecommunications have brought new opportunities, they also present a threat. Market geography has been modified in such a way as to potentially create an international base of investors through terminals in all regions. One of the main exchange reforms was the computerization of trading. We cannot even make a guess what new things competition can or will bring.

More exchanges would mean more competition and in order to survive and grow, they will have to innovate products, change distribution platforms, improve member and customer services, expand the reach, and become cost-competitive, all to the benefit of the common man. This will ultimately help mobilize vast savings and resources from all over India including the rural households to fuel the growth of Indian industry. Those who are weak or lethargic will just fall by the wayside, as we have seen in the case of the regional exchanges.

The issue of ownership

Limitations exist on the ownership, largely aimed at restricting takeovers and preserving the domestic nature of the exchanges. This has left no incentive for other established local or international private sector players to promote and run exchanges in India unlike the banking, insurance, telecom and energy sectors where such onerous ownership restrictions are not imposed. In some private sector banks, promoters have been allowed to hold more than 50 % shareholding. In the commodity exchanges, FMC allows promoter companies to hold 40% in the equity of these exchanges. The FSA in the UK and the MAS in Singapore allow up to 100 percent ownership to local as well as foreign players.

Conclusion

In conclusion, equity markets in India are still at best in a nascent stage with most economic activity outside the listed domain. Add to this the massive potential divestment programme. If the goal of the government is to make every citizen a shareholder in public sector firms, it would require a totally new mechanism and infrastructure to achieve this. Add to that the Bharat Model that would look at not just equity but bonds, currencies, interest rate derivatives and commodities.

`The emergence of competing exchanges will lead to product innovation and deeper penetration. More strong players with rural reach, more market-development initiatives and improvement of the infrastructure of the current players will be critical. It is time the policy-makers work proactively to create credible competition and let the exchanges, existing and new, reach new horizons.

If financial inclusion is the goal, exchanges shall have to look at greater reach, better technology, more products, more listings, lower costs and ultimately get more investors. To bring in more investors, the key will then lie in exchanges being focused on addressing the issue of financial literacy. We will wait for the day when instead of the investor coming to the exchange/brokers, it will be them reaching the investors.