Indian Capital Market – Need for new Paradigm

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The Indian capital market had undergone significant evolution on the regulatory and structural paradigm since 1990s but has not been commensurate with the changes in the product profile, range of services, capital mobilization, cost of raising capital, etc. This looks more prominent when compared with the developments in other emerging markets (including China). The very fact that India has only about 20 million direct users of capital market as opposed to China which has 200 million registered depository users, signifying that there is a lot that capital markets would have to do to penetrate in order to make the Indian growth story more inclusive. Broad based market development has always been the theme around the world as more investor means more wealth creation and distribution in society and also better allocation of risk capital.

With healthy growth and increasing base of our population, the challenge before policy planners would be to turn the healthy economic growth trend of the past decade into an economically and socially sustainable phenomenon. Markets, as institutions which enable democratic interplay of economic forces, play a critical role in making economic growth inclusive and sustainable. Capital markets are no exception to it. In a monetized economy, capital plays the critical role of allocating its resources among those activities that are economically most productive. In doing so, it would also enable all stakeholders of the economy benefit from the returns in proportion to the capital deployed by them. However, it is the ability of these markets to provide free and fair access at an affordable cost through various instruments that could match the investor profiles and expectations would decide if these markets would be able to achieve their critical objective of making market-led growth an inclusive process. Hence, India needs more efficient and well developed and widely participated capital markets that would enable the growth transition to be a smooth process.

Indian capital market development:

Indian capital markets have grown at a CAGR of 14 per cent over last decade, where the entire financial ecosystem has been transformed in the due process. In year 2003 India's market capitalization to GDP ratio was 45%, which escalated to 69% by end of 2012. Simple transition can be witnessed in the trading pattern for cash markets and derivatives markets. In year 2003 cash markets trading was 99.97% of the capital markets, but gradually over the years it's the derivatives (both cash and Index) have scaled up the graph, approximately 91%. Comparatively lower cost of trading and leverage, Indian market participants have switched over the trading in derivatives than the underlying markets.

Over the years it's the technology also that has played a critical role in transformation. This has enabled increase in data processing power, resultant of the technological revolution. Thankfully this has reduced the time lag as well as the cost the involved, facilitating relatively faster output and price discovery mechanism.

Though continuous steps have been initiated by the regulator for the development of markets yet the potential of the country is yet to be fully explored. The demographic dividend advantage is yet to be gained; also the "potential of savings" is going unnoticed; productive and innovative capacity and creative infrastructure facilities are yet not optimally utilized. Hence, what India needs is a sustainable growth approach with inclusive thought process. This would surely able us to see forward India have an upright position in the global financial markets and also have a progressive economy.

- **Manageability of Equity portfolio of Pension Funds**

  Indian Mutual fund industry is managing its AUM (Asset under management) of more than Rs 2.5 Lakh crores (Investment in Equity) as on March 2014. If the pension fund is allowed to invest in Equity to the tune of 10% of its investment, the incremental corpus would be less than Rs 50,000 Crores. This incremental corpus appears, considering the size of mutual fund AUM, to be manageable with ease. Pension funds could start to allocate a portion of their fund, to be invested in equity, through the existing mutual fund. By doing so, the risk of corporate governance will be minimized at two stages, one the entire equity portfolio of the pension fund will be managed by an AMC registered with Capital Market Regulator (Well Governed) and the investment of entire corpus may be restricted to PSUs (Existing and prospective listed companies) and top companies forming part of SX40, Nifty and Sensex. Such investment of 10% of the pension funds in Equity would generate an annualized excess return of more than 100 basis points for the entire corpus. Later, the equity allocation should be increased in phase manner and investment may be broadened to other listed and prospective listed companies as well.

Pension funds alike other institutional investors provide means of risk pooling for smaller individual investors, thus providing diversification and enhanced risk-return opportunities. Their superior capacity to absorb and process information, and their ability to transact in large volumes, not only lowers the cost of intermediation but also benefits investors and businesses and financial institutions alike. In addition to providing better risk management and lower transaction costs, their long-term liability structure allows pension funds to invest in and contribute to the development of longer-term securities markets. They not only contribute to better transparency and governance but also to the overall improvement of market microstructure and market efficiency.

- **Development of the bond market and creation of a parallel market**

  Indian corporates yet believe domestic bank financing is the primary source of funding. However, with the prevalent regulatory procedures, there exists lot of constraints in bank financing. A debt market can certainly provide sources of funding and liquidity, with a mechanism for mitigating risk. Development of corporate bond market shall facilitate financial intermediation, allocate the "surplus" to the "deficit" and make credit movement easy and also transparency and discovery process can be enhanced. Indian bond market at a very initial stage is also exposed to several whipping scenarios like, high rates, volatility in USD rates, investment grading or India etc.

  a) Transaction only through Stock Exchanges**:** It should be mandated to all Mutual Funds, Insurance, PF, Pension & Gratuity Funds to Purchase & sale of Bonds only through the Exchange platform irrespective of nature of bonds i.e. Issued on Private Placement Basis or through Public Issuance. This will enhance activities in the bond market. In short, instruments like Commercial paper (CP), Certificate of deposit (CD), Other Bonds etc. on the exchange platform will help in building good liquidity for all investors and may also develop the money market credit yield curve. It will bring in transparency and help to increase participant base.

  b) E-Issuance of Corporate Bonds through Stock Exchange window: All issues Corporate Bonds, issued to public or privately placed basis should be compulsorily brought in electronic mode through Stock Exchange. It will help the issuer in reducing the cost as well as the time involved, by the process of distribution through exchange network. It will also have wider distribution of bonds in hands of various investors reducing the gap with the current mode of public issues. The few of other benefits are wider Investors reach, real time monitoring of subscription, transparency in pricing and allotment, reduced the investor grievance post issue and overall price efficiency and parity in the bond market. The E-issuance system being envisaged is for facilitating issuance whereby electronic subscription shall be received by brokers and entered electronically into the electronic platform provided by the Exchange.

  c) Guarantee by Banks for Bond Issuers: Banks by reducing their lending to top corporates & instead guaranteeing the bonds issued by them will also provide confidence amongst the investors in investing in safer rated instruments and increase participation, while the banks with their expertise of lending can concentrate in lending to medium to small corporate which will help in scaling up medium to small enterprises.

  d) Encourage or allow Re-issuances of Bonds: The yield and liquidity of the issues vary across the issue categories. The Indian debt market is primarily driven by private placements and it is estimated that over 90% of debt issues are placed privately and such issues dominate over public issues. The demand is pre-dominantly for highly-rated issues and investors are primarily institutional investors which are limited to insurance companies, pension funds, mutual funds and commercial banks. Cap on investment, ratings valuation, mark to market for Banks and Insurance companies have affected institutional activity.

  The very nature of the instrument which ceases to exist on maturity unlike equity which is perpetual in nature has its effect on the liquidity of the instrument and multiple issuances from a single issuer. Such problem has brought in illiquidity to the bond market and mispricing of the securities across tenures and ratings. Re-issuance is the ideal option whereby the issuer continuously re-issues the existing securities and thereby enhances liquidity and efficient price discovery.

  The primary corporate bonds market has seen significant growth in terms of issuance but not in terms of trading activity mainly due to multiple issues leading to fragmentation and illiquidity. Currently there are more than 15,000 securities and 14 lakh crores of issued market capitalization with over more than 700 issuers. Approximately 20 issuers have more than 100 ISINs and over 50% of issue market capitalization. Reissuance is a must to develop and create liquidity in the corporate bond market and in developing of a credit yield curve for an issuer and enable efficient pricing. Re-issuance will also help the issuer price the bonds to be reissued at market rate and eliminate valuation problems by the asset management companies.

e) Taxation Benefits: Retail individuals should be encouraged to invest in corporate bond & government securities through Stock Exchanges and should be allowed to enjoy tax free interest income with an upper cap of say Rs. 1 lakh on the interest income beyond which the interest income will be taxable (i.e. interest from government security like earlier section 80 of Income Tax Act should be exempted from income tax). Putting a large cap of Rs. 1 lakh will motivate individuals to plan their savings to take tax benefits. Such benefits should be over and above benefits under Section 80 C.

f) Consistency and standardization in coupon frequency and day count conventions can certainly built up a healthy debt market. Normally volumes are only observed at the short term end of the bond; however this causes long term asset – liability mismatch. Hence a policy needs to be encouraged for developing long and stable long term debt market, which can also justify for long term gestation period infrastructure projects. This can enable us to have a stronger yield curve and also not restrict our base to only AAA rated bonds.

- **Widening the distribution network**
  Other major challenge lies in dispersing trade concentration and it can only be altered through spread of market participants across geographically as well as the economic strata. The participation in the real capital formation through risk capital shall be the obvious choice of the investors than just focusing on the fixed interest based investment. While, widening distribution network through channels of financial mobilization such as Banks, Post-Offices etc. would help the same. It would have to be complemented with increasing efforts on educating the retail participants with about various investments and trading motives along with associated risk. It would encourage real capital formation helping the entrepreneur with domestic funds which would have prime domestic interest in perspective compared with the foreign capital that the market is currently dependent upon. If banks are allowed to distribute financial instruments at reasonable fees, it could channelize savings of financially literate investors and could widen the income base of these very banks from increasing dependence on rate differential and diversify into increasing fee based services.

  Another way to look at, they can provide all services under one roof essentially empowering retail participants as like their institutional counterparts. The need of the hour is organizing the unorganized sector and therein lies the really challenge for policy makers.

- **Value through wealth Creation and innovative products and customer awareness**
  If pension funds were allowed to participate in the Capital Market in India then they would have generated a higher return than their managers had as obligation. Hence, the value proposition has to be with returns and performance of the product on lines with the specific customer need. Also alongside products have to emerge that can match with the investor horizon. Depending of products like mutual funds, pension funds, insurance etc. shall also make a favourable platform for corporate bonds growth and developments.

  ETF's due to its inherent feature of low cost, higher transparency and liquidity are favored globally. Hence they also have to be popularized as an efficient source of investments, fetching higher returns.

  Though lot has been said and done for enhancing customer awareness, it is the lack of knowledge of capital markets refrains individuals from participating in the same. There is also a perception from the educated class, about investment in capital markets being unsafe. It is this ignorance that yet needs to be addressed at large. When a typical investor gets caught in wrong cycles, they wade away from investing hence forward. Hence, it is the right set of knowledge that has to be consciously imparted to clear the ignorance that exists.

- **Strong enforcement regime**
  Any kind of misrepresentation of facts / wrong disclosures in the disclosure documents / offer document during any public offering of otherwise may create a disorder and distortion in the effective functioning of market. In view of the same, it is important to have disclosure based regime, however, we also need to have a Strong enforcement mechanism to create fear of law and that may prevent wrongdoings.

  Indian Markets have so far not observed prompt and severe actions against issuers / companies who were involved in wrong doings.

- **Broadening Equity Linked Saving Scheme - Individual Savings Account**

  An Individual Savings Account (ISA) is a financial product available to residents of the United Kingdom designed for the purpose of investment and savings with a favourable tax status based on Tax-Exempt-Exempt model. Cash and a broad range of investments can be held and there is no restriction on when or how much money can be withdrawn. Though, this is not a pension product but may be a useful complement to a pension for retirement income. There are two broad types of ISA, cash or stocks and shares.

  Cash ISA is a cash deposit that is similar to any other ordinary savings account, apart from the tax-free status. In stocks and shares ISA, the money is invested in 'qualifying investments' - various direct and indirect capital markets based financial instruments. As a consequence, the risk profile of the ISA may be anything from low to high depending on the mixture of investments used. In addition, UK also allows Junior ISA which allows parents to invest money in the name of children to be withdrawn at a later point of time. Such facility should be announced in India to boost the investment culture in Capital Markets.

Conclusion: Need for 3rd Generation Financial Sector reforms

In a country with population of about 1.2 billion plus having a saving rate of equivalent to 32-33 percent, merely 2 percent of them are participating in Indian Capital Market throws structural opportunities that the market can achieve through increasing intermediation and market literacy.

Nearly 55 percent of savings are being routed into physical assets, which are unlikely to earn a real return as inflation levels are way higher. This composition clearly indicates that Indians are great at saving but lagging behind as investors.

Current intermediation by Stock Exchanges has not done enough to channelize domestic retail investors and their saving to the Capital Markets. Support to healthy Competition by policy makers and technology would be the key driver which will help in grooming the domestic investors from basics of capital market investments and through arming with necessary information as available with their institutional counterparts.

Indian capital markets have come a long way from its "old" and "traditional" image. It is gradually progressing to a modernized market, with several opportunities available. One has to bear in mind that it also the intelligent and aware investor that one needs to answer. Hence, India can no longer count on the past performances, which certainly have brought credentials to Indian markets, but now the financial ecosystem has changed. The regulatory regime has transformed and reformed a lot since last decade. With globalization in the forefront the ideology also needs to be reframed accordingly. Indian markets are at stage of parallel development as well as evolvement. While efforts for increasing the financial literacy are being undertaken, the next obvious step for policy makers would be to widen the equity culture in the Indian economy and also to promote self-sustaining economic activities for long-term economic health of the nation.