Building Better Financial Markets: Lessons from Indian Equity

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1 Introduction

The Indian equity markets are held up as one of the success stories of the reforms that was the response to the crisis of the 1990s. In the wake of this success, came a focus on developing the Indian financial sector as a source of earning global revenues. But since the release of the report on developing India as an International Financial Center (Percy Mistry Committee Report, 2007), a decade has elapsed with little implemented of most of the substantive recommendations made in the report. Instead of becoming a global center for financial services, evidence shows that India is losing global market share on Indian assets. For example, over the last decade, two of our biggest financial markets - derivatives on the rupee and on the equity market index (Nifty) - have started trading globally. The offshore volumes in these two assets add up to a daily turnover of just under USD 20 billion (out of the total market size of USD 63 billion). India faces the danger of rapidly becoming a case study of how poor development of domestic markets can erode their home advantage over offshore markets. In this article we analyse the domestic market for Indian equities and ask why and how this market is losing out to offshore markets. We then identify policy issues that can rectify the loss in market share.

2 Market development and reliable access to capital

A critical element of becoming a competitive market is a ready and reliable access to capital: there must be access, and the access must be taken for granted all through the life cycle of a firm and an investor. This means accommodating different levels of returns and risk at different times. The markets in most small and emerging economies suffer from the problem of limited domestic capital. In order to compensate for this, these countries make an effort to attract foreign capital into their markets, and reduce biases between domestic and foreign investors. The Indian equity market does not fare well either in having low barriers to capital ows, or in having an enabling framework to ensure this. In the following sections, we present evidence regarding the barriers to capital access and the costs of access to the markets.

2.1 Barriers in access to capital

Globally, the largest order ow into equity markets comes from financial institutions like banks, insurance and pension firms that take the long horizon investment savings from households and channel them into securities and loans to

Table 1 Participation by domestic institutions in equity markets, 2013

	AUM (Rs. bn)	Equity (Rs. bn)	Fraction in equity (%)
Banks	1,07,985	574	0.5
Life Insurers	20,068	5,263	26.2
General Insurers	1,278	318	24.9
EPFO	7,700	0	0
NPS	481	41	8.5
Total	1,37,512	6,196	4.5

Source: Data for banks comes from CMIE Prowess, for Life Insurers from the Life Insurance Council of India Annual Report, General Insurers from the General Insurance Council of India Annual Report, EPFO from the EPFO Annual Report, and NPS from the NPS website.

maximise return for risk taken. In India, most of these institutions are government owned entities whose investment mandates tend to be heavily weighted on investment in government securities. Table 1 presents the proportion of equity in the Assets Under Management (AUM) of these firms. We see that equity, an asset class with one of the highest expected return to risk ratio, has very low allocation.

All across the world, firms and investors have a home bias. This means that domestic savings and domestic institutions are critical to domestic market development. In the case of equity market development, domestic institutional investors have been, by design, limited in their role and there is little that Indian policy has actively done to mitigate this bias. This has, for the equity market, created an increased reliance on foreign capital.[1] Despite this, foreign investors face several levels of constraints on trading in Indian markets. It starts with onerous registration and compliance requirements for participating in investments onshore. They have to register as Foreign Portfolio Investors (FPI) or come through Foreign Direct Investment (FDI) route for investing in listed equities. Globally, the registration and customer due diligence requirements follow a standard form which is agreed upon by the Financial Action Task Force (FATF) signatory countries. Indian requirements have often been described as FATF plus. The FDI route also has challenges in the form of entry and exit constraints.

A second and more subtle barrier that is presented to foreign investors is India is the segmented market design. This can be particularly expensive for global investors who are used to running a single book to enter and then manage a country portfolio, with returns and risks that are adjusted to the currency of their choice. In India a dollar return for a foreign investor means different rules to be followed for investment in equity issuance, equity trading, equity derivatives and currency derivatives markets. Capital is not seamlessly managed, and worse, foreign investors face different rules in how they can participate compared to domestic participants.[2]

Another barrier is the high cost of trading. Cost of trading in the Indian equity exchanges is estimated at 43 basis points compared to global competitors at 16 bps (Mohanty, 2011). A significant component of the cost in India is the high level of statutory levies in the form of securities transaction tax (STT) and stamp duty. Global centers for financial services have experimented with STT and removed it. In India however, not only is STT levied, but its incidence is used to determine the direct tax rates.[3] This creates anomalies and increases uncertainty in investment returns for all investors.

Tax policy also drives up the cost of trading for foreign investors in India in other ways. India follows a source based tax regime while global capital ows come from residence based regimes. This results in compliance costs to claim double tax avoidance agreements (DTAA) exemptions. Costs also arise due to uncertainty in implementation of tax policy, such as the Minimum Alternate Tax (MAT) on capital gains for foreign investors.

But perhaps, the greatest bottleneck to stable long term capital inows comes from a lack of certainty on policies affecting investments. These may be policies on market access, market regulations or tax. For example, investors face regulatory uncertainty from regulatory delays[4] or from sudden changes in regulation.[5] High levels of costs by themselves act as a barrier which can be overcome by high returns. But policy uncertainty disincentivises market participants from taking a long term view. This risk makes Indian markets a target for short-term investors, and turns away long-term investors. This outcome is not optimal for India.

With such constraints, the equity markets in India continue to have features that are characteristic of markets with low capital access. Table 2 shows the secondary equity trading from October 2014 to March 2015 for the best traded firms at both the NSE and the BSE, a sample of approximately 3,600 listed firms. It raises several concerns about the equity trading in India.

Table 2 Equity trading in India

	Total Market Cap (USD Billion)		Avg. Daily Volume (USD Billion)		Turnover Ratio (Percentage)	
	Q4-14	Q1-15	Q4-14	Q1-15	Q4-14	Q1-15
All firms	1527	1600	3.06	3.53	0.16	0.17
D1	1409	1480	2.61	3.10	0.15	0.16
D2	77	80	0.34	0.31	0.26	0.23
D10	0.12	0.11	0.0001	0.0001	0.02	0.02

Q4-14 denotes October-December, 2014; Q1-15 denotes January - March, 2015

D1 denotes rst decile, D2 denotes second decile, and D10 denoted tenth decile of rms based on market captilisation. There are approximately 360 rms in each decile.

Total market capitalisation is computed on the rst day of the quarter for NSE and BSE listed rms.

Average daily traded volume summed across rms at BSE and NSE

Daily turnover ratio, $TR = \frac{volume}{mcap}$

Trading is concentrated in the top decile of firms **(D1)**. Other than for the largest 350 firms, there is hardly any market liquidity.[6] This skewed liquidity in the onshore markets, in turn, has an adverse impact on domestic firms seeking to raise equity capital. They have an incentive to explore offshore markets where, higher liquidity in the secondary market indicates higher availability of capital. This is likely to enable better valuation of equity at issuance, and also better access to capital for follow-on activities such as follow-on issuance and mergers and acquisitions.

2.2 High costs of procedure in equity issuance

In addition to the above disadvantages of lack of a deep and liquid secondary market, the Indian equity issuance market also faces other challenges. The Indian IPO market has high procedural costs, which show up as high issuance costs and greater time to issue compared to global exchanges. Table 3 shows that the median cost to issue in India is between 6% to 8% of the issue size. The median time taken to issue is more than 200 days and ranges from a minimum of 30 days to a maximum of 737 days. Much of the time taken, approximately 60%, is on account of regulatory approval delays. Given the volatility in equity markets, certainty in time to market is a critical element of the issuance process for both issuers and investors who are exposed to market risk in the interim.

Table 3 The time and cost of equity issuance, 2006–2014

Issue Type	Issue Details				Issue Costs		Time to Issue			
	No. of Issues		Issue Amount (USD Million)		Cost (Percentage)		Regulatory (days)		Total Time (days)	
	P1[1]	P2[2]	P1	P2	P1	P2	P1	P2	P1	P2
IPO										
Private small[3]	115	47	9.9	11.8	8.5	8.0	108	145	178	216
Private large[4]	107	62	45.7	48.8	6.8	6.7	83	116	119	193
PSU	7	7	377.8	102.8	2.2	3.1	49	42	146	62
FPO										
Private small	13	2	5.8	7.6	9.1	8.8	94	161	163	198
Private large	11	1	60.1	741.6	6.0	3.5	45	-	98	-
PSU	3	9	127.6	976.5	2.8	0.7	21	30	58	44

Source: Prime Database. Issue size, cost, and time taken are median values over the defined periods. Only main board issues are included.

[1] P1 denotes 2006 - 2009.

[2] P2 denotes 2010 - 2014.

[3] Private small are issues by private firms where issue amount < USD 20 million.

[4] Private large are issues by private firms firms where issue amount > USD 20 million.

Table 4 compares the NSE on various elements of the issue process against the U.S.[7] and the Far-East Asian markets.[8] There are three observations.

1. Issuance in India has cost structure that is largely fixed. Advisory, underwriting, legal fees and printing costs, form the bulk of the costs and do not vary much with issue size.

   This means that small firms/issue sizes tend to face a much higher cost at around 10% of the issue size.

2. In India, compliance and disclosures requirements for listed companies are not as stringent as on OECD exchanges. This results in lower costs bu poorer corporate governance, which adversely affects investors interests.

   Compliance costs on the NYSE and NASDAQ, where there is consistently higher issuance and trading than in India, are at USD 1.5 - 2 million per year.

3. Regulations governing corporate action for listed companies, such as M&A, takeovers, secondary equity offers and de-listing are more challenging in India compared to the OECD exchanges.[9]

Table 4 Comparison of Equity Issuance, NSE vs. competitors

Factor	NSE	NYSE/NASDAQ	SGX/HKSE
Availability of capital	Low	High	High
Cost of issue	6-7%	6-7 %	NA
Time to issue Certainty about time	6-7 months, Variable	4 months, Certain	6 months, Variable
Post-listing costs	Relatively low	High	NA
Post listing compliance	Relatively low	High	NA
Operational flexibility	Low	High	NA
Regime	Merit based	Rule based	Merit based

Source: Freshfield Bruckhaus Deringer, IPO requirements, April, 2014; NSE website; SEBI ICDR Regulations, 2009

This reduces the attractiveness of the domestic markets for issuers.

Global markets that offer higher certainty on time to issue and better valuations at similar cost of issuance as the domestic markets become more attractive to domestic firms. Global exchanges also offer reputation benefits on listing. These factors are specially important for firms where valuation is uncertain, such as for new technology firms and similar start-ups.[10]

3 Implications for policy

Financial market development in India over the last decade has improved but has come nowhere close to being competitive internationally. At the same time, competitor markets such as Singapore and London are increasingly becoming viable alternatives for Indian assets trading. As these markets build liquidity, their ability to attract capital ows will improve, at the cost of loss revenue for domestic markets in India. If India does not act with urgency, this loss will become irreversible.

The countermeasure is to identify what prevents better domestic market development and amend policy appropriately. The first step is to correct errors in regulations. Constraints on domestic institutional participation, foreign participation, problems in market regulations fall in this category. The second is to create an environment of regulatory and policy certainty. Indian financial markets frequently face a real risk of products and services being banned, or tax policy being changed on a prior period transaction, or of margins being sharply raised, or of position limits being sharply cut.[11] This often takes place without warning or rationale. When faced with such risks, cautious financial sector participants become reluctant to invest long-term resources to build a business. Foreign and domestic participants will choose to conduct business in jurisdictions with greater certainty, such as London or Singapore, rather than in India. To address this, financial sector regulators need to improve their standards of rule making. The implementation of the Handbook on adoption of governance enhancing and non-legislative elements of the draft Indian Financial Code (Handbook, 2013), will go a long way towards this. A similar approach needs to be adopted by government and tax authorities.

Lack of international competitiveness is not just about foreign investors. It is about creating an ecosystem which benefits both categories of participants, domestic and foreign. Large domestic firms and investors have the ability to overcome domestic constraints by accessing offshore markets for financial services. For the remaining participants there is only the domestic financial system. Competing with the world has worked very well to improve the domestic economy in numerous sectors, and finance is likely to be no exception. International competitiveness of Indian finance is an idea that needs to be embraced, in the interest of developing a vibrant domestic market which can support the growth of Indian economy.

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[1] In march, 2015, foreign portfolio investors (FPIs) owned nearly 25% of the market capitalisation of Indian equities, approximately USD 320 to 350 billion.

[2] For example, FPIs are not allowed to post equity securities or units of liquid MFs, unlike domestic participants. FPIs cannot cross-margin between cash and derivatives if they post government securities as collateral while domestic participants can.

[3] Lower rate of short term capital gains tax, 15% with STT and 30% without STT. Similarly, long term capital gains tax exempt with STT and 20% without STT. Levy of STT also used to determine whether a transaction is to be treated as speculative or non-speculative for the purpose of tax. Speculative transactions attract higher taxes.

[4] As in the case of delays in approval for draft offer documents by SEBI.

[5] On July 13, 2015 SEBI increased the market lot size for equity F&O from Rs. 2 lakhs to Rs. 5 lakhs. This was done without consultation with market participants and any cost benefit analysis.

[6] This is a recurrent feature across all of India's equity markets. For example, in the Nifty options market which is the largest equity market segment, only about 17% of the trades are by institutional investors (Grover, 2015).

[7] This includes NYSE and NASDAQ.

[8] This includes SGX in Singapore and HKSE in Hong Kong.

[9] For example: De-listing is permitted only after a 95% buy back of shares and at least 25% of the public shareholders by number tender their shares for de-listing to be successful. This stipulation makes it very diffcult for a company to de-list. In comparison, on the NYSE, de-listing and buy back are treated as separate events. A buy back of shares may precede de-listing but not necessarily so. De-listing can be done by giving a 10 day notice in the U.S. markets.

[10] Clearing the Decks: SEBI eases norms for new age start ups but bottlenecks remain, Business Today, July 2, 2015 (http://businesstoday.intoday.in/story/ sebi-eases-norms-for-new-age-start-ups-but-bottlenecks-remain/1/221095.html)

[11] July, 2013 FX defense measures for the exchange traded currency derivatives market by RBI and SEBI.