Emerging Role and Responsibilities of Indian Stock Exchanges

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The recent years have been of greatest challenge for stock exchanges worldwide. The financial markets have undergone rapid changes the impact of which was intensely felt in the capital markets. The major changes are brought out by the rapid developments in technology and globalisation, leading to a great surge in the products and services as also the platforms and distribution systems offering these services. A few of these changes were evident in Indian capital markets also. This article discusses in brief the major role and functions of the stock exchanges in India and the responsibilities arising from the emerging challenges.

Objectives of Capital Markets

Capital markets are an important component of any country's financial system. The role and efficiency of capital markets in helping the growth process of the real economy is widely documented in international finance. Several studies indicate the important role played by the market-based systems, which have strong capital markets as contributing sizeably to the robustness of the economic growth.

The major functions of the capital markets include:

Mobilise savings for capital formation
Efficient allocation of resources/savings
Reduce cost of capital by providing risk capital at low cost
Attract foreign capital
Enhance shareholder wealth
Facilitate privtisation/mergers&acquisition for better capital efficiency and industrial productivity

Indian Capital Markets

- ***24 recognised stock exchanges***
- ***Automated Trading and Settlements of Trades***
- ***BSE and NSE major national level stock exchanges***
- ***Settlement of Securities through Depositories***
- ***T+3 Settlement Cycle***
- ***Largest number of Listed Companies in the World***

Profile of Indian Capital Markets

- ***Lower level of Institutional Trading (10 to 15%)***
- ***Predominant Retail Trading***
- ***Provident/Pension Fund not permitted to invest in equities***
- ***Limited role of banks and insurance companies***

Role of Stock Exchanges

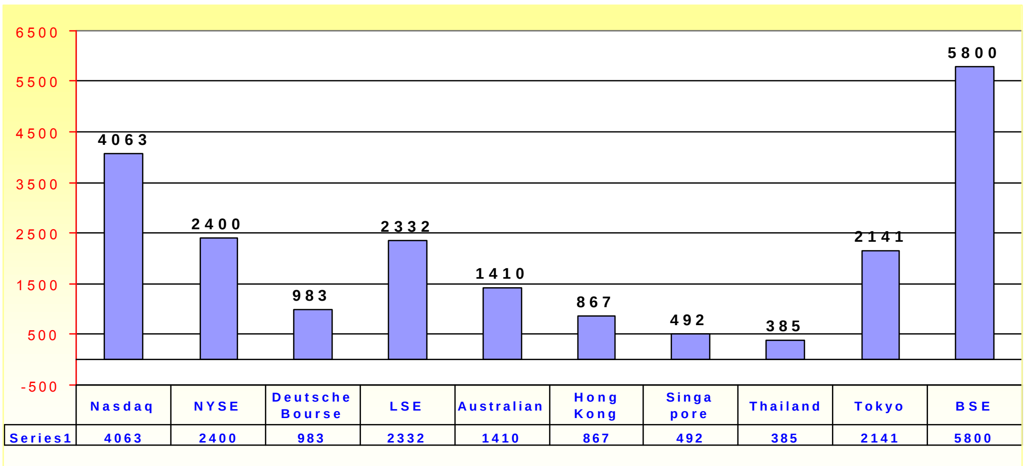
Stock Exchanges are important instruments of an institutional framework that determines to a large extent the growth and development of capital markets in any country. Well managed stock exchanges play an important role in developing the depth of the capital markets, which is crucial for enhancing the efficiency of capital markets.

India has a long history in the development of stock exchanges. The Stock Exchange, Mumbai established in 1875 is one of the oldest capital market institutions in the world. That a country such as

India has established a stock market entirely conceived and driven by indigenous enterprise and initiative speakers of the excellent financial skills India is endowed with since long. That was evident in the recent round of economic reforms also, when a number of measures were introduced to increase the efficiency in the functioning of the stock exchanges as also transparency in their operations. A few of these include:

- Shift from Open Outcry to Electronic Trading
- Settlement of Securities through Dematerialization
- Settlement period bring brought down to T+3 (three days after the transaction took place)
- Increased competition among the stock exchanges
- Introduction of Derivatives
- Strengthening of Surveillance mechanisms
- Rapid absorption of Technology in all spheres of stock exchange functioning
- Improvements in the quality of Investor Services

Number of Listed Companies: Selected Stock Exchanges



BSE as a part of its operational agenda has emphasized on several other significant aspects such as bringing greater efficiency in transaction costs, spread investor education and awareness and create appropriate mechanisms for grievance redressal for investors etc., A study by the Securities Exchange Board of India observed that trade execution cost of equity shares is found to be lower at BSE as compared to other exchanges. For instance, in February 2001, the minimum effective spread at BSE was found to be 0.44 as compared to 0.84 for other major exchanges, Minimum effective spreads at BSE were lower at most of the periods for which the observations were taken for the study. Effective Spread is an indicator of actual cost incurred by an investor to execute a trade. Similarly on the investor protection front, BSE offers maximum compensation of Rs.10 lakhs per investor as against valid and approved claims, which is again, the highest offered by any exchange in India. On the education front too, it expanded rapidly, with a full-fledged training institute that trains thousands of capital market professionals every year on a wide range of subjects on capital markets and financial sector.

The establishment of National Stock Exchange has revolutionized equity trading in India with the entire country being given access to the equity trading. This boosted the investor base of the country immensely, which at the last count, is estimated at about 20 million. National Stock Exchange has also contributed significantly in promoting screen based trading, reduction in cost of trading, development of derivatives screening of brokers and enforcing some eligibility criteria and also actively participated in the development of dematerialization and depositories across the country. It also played a significant role in the development of wholesales debt segment

The fusion of these developments makes stock markets in India an important segment of the India's financial system. These developments ushered in rapid developments in the growth of Indian capital markets, which was in tune with the international trends. Between 1999 and 2000, the combined market capitalization of a few select emerging equity markets (among which India is one) increased from US$339 billion to US2.2 trillion. As a share of GDP, the average market capitalization in these countries increased from 16.7 percent to 45.5 percent during this period and their share in the world market capitalization increased from 3.6 per cent to 7 percent. The annual value of shares traded in these countries increased from US$180 billion to 2.2 trillion and the turnover ratio jumped from 32 percent to 62 percent.

These trends were evident in India too. The market capitalization of the BSE as a percent of Gross Domestic Product rose from 13 percent in 1990 to 47 percent in 2000. Turnover ratio jumped from 6 percent to 35 percent during this period. Market capitalization of BSE as a percent of assets of scheduled commercial banks increased from 28.4 percent in 1990 to 79.3 percent in 1999. The lead taken by the Indian capital markets in promotion of derivative products is unique for emerging economies.

As intense the growth of the stock markets has been in the 1990s, the beginning of the decade of the 2000 were rather tough and challenging. Stockmarkets all over the world experienced sharp contraction in the new equity issues and trading volumes and India is no exception. In India from the peak 2000 levels, trading volumes are almost down about 70 percent. Market capitalization also eroded significantly. Several reforms were introduced that address the stock markets directly a few of which include; introduction of T+3 settlement, ban on deferral products like Badla and the ALBM, uniform settlement cycles across all the stock exchanges and greater transparency in operations and strengthening of surveillance mechanisms.

In this background, issues on the emerging role and responsibilities of the stock exchanges assumes greatest significance. A few of the issues that are of greater urgency to be addressed to are discussed in this article.

The primary role of the exchange lies in providing secondary market liquidity and price discovery, for fair efficient and transparent securities markets to facilitate raising of capital by commercial enterprises for sustained economic growth.

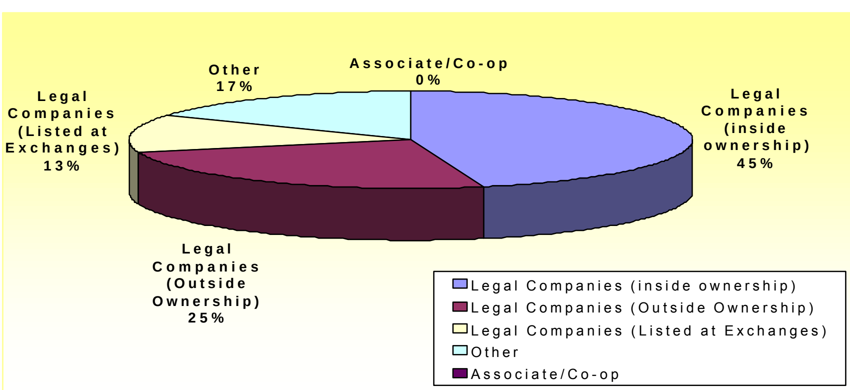
Role of Stock Exchanges

- ***Provide a fair and transparent trading platform***
- ***Facilitate liquidity for listed scrips***
- ***Enable efficient price discovery***
- ***Ensure market safety through comprehensive risk management measures***
- ***Strive to maintain market integrity through surveillance systems***
- ***Improve transparency, disclosure norms and corporate governance by listed companies***

Demutualization" and "For Profit" Corporate Structure

For long stock exchanges were 'not for profit' associations formed by brokers. This trend however underwent significant changes in the 1990s with a number of stock exchanges following the process of demutualisation where ownership and trading rights are segregated. Singapore Stock Exchange was one of the first few to be demutualised by the merger of the Singapore Stock Exchange and the Singapore International Monetary Exchange, which was formally inaugurated in January 2000. Soon followed demutaliseation of several stock exchanges

Chart: Legal Status of Selected Stock Exchanges in the World



such as London Stock Exchange (February 2000), Oslo Stock Exchange (April 2000), Winnipeg Commodity Exchange (January 2001) etc. In most of the cases where the Stock Exchanges are converted to "For Profit" enterprises, shareholders, principal customers and decisions makers are arranged into three distinct groups. The imperatives for outside ownership have come from the need of large investments required in technology, which the exchanges were not always able to raise from its members. The change in Governance structure is required to enable faster decision making as well as to remove any perceived conflict of interest.

Regulatory Role & "Conflict of Interest"

The exchanges have an important regulatory role both in terms of companies listed on the exchange as well as the members who are trading on the exchange. There may be a conflict of interest if these interests are represented in the governance structure. There may be a more subtle conflict where a regulatory action may result in reduced business and have a direct bearing on the "for profit" motive of the exchange. The former can be addressed by writing and enforcing an appropriate code of ethics. While the latter would be automatically addressed by the "For Profit" motive, where to be a preferred exchange and attract genuine business in the long run, it must take all regulatory steps in order to keep the markets safe and efficient.

Technology

Technology is an important aspect of the functioning of the stock ex change, since all its major functions in the realm of trading, securities settlement, surveillance are entirely driven by technology. While it could be a major cost center for any exchange, simultaneously, it also provides them with enormous opportunities in product design and development and delivery and distribution. Stock exchanges with prowess in technology management are the ones who could see possibilities of surviving in these extremely competitive environment. As long as technology serves as an important instrument of business strategy, stock exchanges could derive great benefit from this. In India, in the recent years, each and every aspect of stock market functioning is technology induced, be it the online trading platforms, risk management or the dematerialization and depositories. Technology also played a crucial role in the product development of derivatives and managing their risk. Technology in the Indian stock markets is pertinent from the following aspects:

- For developing trading platforms in equity, debt and derivatives
- Expand the reach of trading platforms
- Risk Management
- Securities Settlement
- Product Development
- Generating Databases

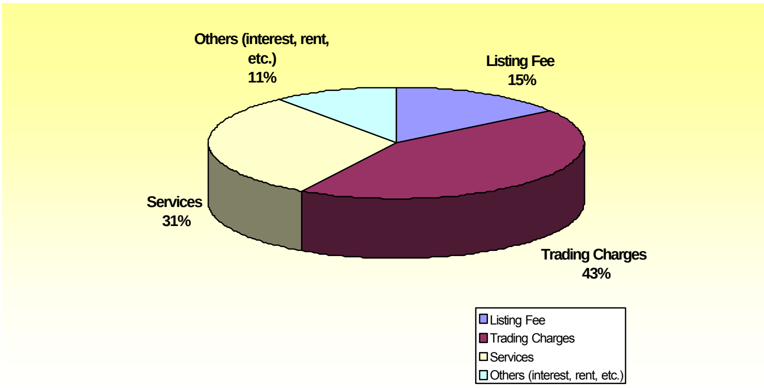
Stock exchange should be able to make sizeable investments in technology and more than that, its efficient use and implementation so as to derive greater benefits that strengthens the competitive advantage.

Investor Protection

Investor protection is an important function of any stock exchange. Indian stock exchanges have evolved a number of mechanisms to strengthen investor protection and also address to their grievances. A few important aspects that assume significance from the point of view investor protection include:

- Increasing market integrity through better surveillance and risk management measures
- Strengthening Trade Guarantee Funds
- Evolving exclusive Investor Protection Funds
- Promote Investors Associations/Forums
- Extend Investor Education and Awareness
- Ensure compliance by corporates of listing norms and conditions

Chart: Revenue of Selected Stock Exchanges in the World



Revenue Streams

Traditionally stock exchanges have been deriving most of their revenues from the listing fees and the turnover. With intense competition in the business trading costs have been declining rapidly and so as the revenues from it. There are always limits to listing since any prudent stock exchange would take great take care in listing only those companies, which have better credentials. On other side, costs for the stock exchanges are always on the rise due to increased costs of technology services and continuous investments in new technology and skilled manpower and business development. These developments induced stock exchanges to scout for new avenues of revenue generation. Many modern stock exchanges earn sizeably from the data products and other technology related services. In some stock exchanges in the world the proportion of such income is as high as 50 percent of the total income. There is a greater need for the Indian stock exchanges to diversify their revenue streams so that their success and sustainability increases.

Consolidation of Exchanges

Consolidation or mergers is sweeping the stock exchanges worldwide, a few of the indications which are evident in India also. European stock exchanges underwent a series of mergers and the Euronext borne out of merger of a few of major stock exchanges is giving tough competition to other national stock exchanges. In India, following the several measures in capital markets which led to rapid erosion of trading volumes in the regional stock exchanges, many are contemplating and in various stages of consolidation and merger with national stock exchange such as BSE and NSE. Consolidation assumes significance from the following aspects:

- Exchanges need to come together specially to share the high development costs in technology.
- Members given access to each others trading platforms. Common settlement and listing are some other areas from which exchanges could derive greater benefits.

In Conclusion

In the background of a wide range of issues emerging importance and significance, the exchanges will face intense challenges in the near future. . There ability to survive will depend on their refocusing of the organization as a dynamic business machine not only providing an efficient, fair and transparent secondary market trading but also servicing its key stakeholders – the investors, the corporates, the members, the regulators, the employees and the public at large.