Future of Small Stock Exchanges and the Role of ISE

Joseph Massey
Managing Director
Inter-Connected Stock Exchange of India Ltd.

There are 25 stock exchanges in India and most of these exchanges were given recognition during the last two decade. While most of the exchanges flourished during the years 1990-94, they began to suffer during the subsequent years due to various factors which affected the business of the brokers and the finances of the exchanges. The period of 1995-98 was the most difficult period for the brokers due to depressed market conditions, problem of paper in the market, implementation of automated trading increased the cost of operations of the traders and exchanges and also depleted the finances of the exchanges. There has been a significant recovery since then and the BSE SENSEX has recovered from a low of about 2800 in 98 to a high of about 6000 in February 2000.

However, what is distressing is that the growth of exchanges during this period has been lop-sided with the premier exchanges, like, NSE, BSE, CSE and DSE witnessing most of the growth and the balance exchanges losing business even further. During the year 1998-99, the four exchanges did an aggregate turnover of Rs. 9.5 lakh crore (92.8 per cent) in the total turnover of Rs. 10.23 lakh crore as against a turnover of Rs. 8.2 lakh crore in a total of Rs. 9.08 lakh crore (90.8 per cent) in 1997-98. Thus, we see that the regional exchanges are not benefiting from the substantial increase in the business volume over years as the volumes are more and more getting directed towards NSE ad BSE. Placed below is the market share of the major exchanges in the total turnover during the last four years.

Year-wise % Turnover of Exchages

Exchange	98-99	97-98	96-97	95-96
NSE	**40.49**	**40.71**	**45.58**	**29.97**
BSE	30.49	22.82	19.24	22.02
Calcutta	16.79	19.67	16.35	27.32
Delhi	5.06	7.47	7.53	4.43
Others *	**3.53**	**4.98**	**6.56**	**9.19**
Ahem'd	2.91	3.39	3.18	3.86
Pune	0.73	0.95	1.53	3.11
OTCEI	0.01	0.01	0.03	0.10
All-India	100.00	100.00	100.00	100.00

** Others include the 15 Exchanges which have promoted ISE.*

However, this phenomena gets better understood if we analyse the source and city-wise distribution of this business getting routed to NSE. We find that the extent of business getting routed from Regional Stock Exchanges (RSE) centers to NSE was about 50 per cent of the total turnover on NSE. The same also holds true for BSE. Accordingly, we find that the turnover emanating from the RSE's to NSE and BSE is over Rs. 750 crore a day. This has happened because of the expansion of trading facility of NSE and BSE across the Country. Lack of liquidity which in turn was a cause and effect of flow of business to the NSE and BSE. It is therefore seen that the RSE's are in a vicious circle.

The extent of business that is getting routed to NSE from the RSE locations to the NSE and the business that is getting done at the local Exchanges during the last two years is given below. We find that in 1998-99 over Rs. 66,000 crore of business was routed from these cities as against Rs. 45,000 crore of business in 1997-98.

Turnover - NSE v/s 15 RSEs

Stock Exchanges	Turnover (1998-99)		Diff. (Rs.cr)	Turnover (1997-98)		Diff. (Rs.cr)
	NSE	RSE	NSE-RSE	NSE	RSE	NSE-RSE
Bhubaneshwar	548	77	471	548	202	346
Madras	17611	370	17241	16850	1228	15622
Cochin	2735	773	1962	2391	1783	608
Coimbatore	3978	395	3583	4224	2136	2088
Guwahati	768	30	738	768	20	748
Hyderabad	12722	1276	11446	8804	1860	6944
Indore	3149	1	3148	2137	1	2136
Jaipur	4351	65	4286	3501	431	3070
Mangalore	486	11	475	486	308	178
Magadh	444	0	444	444	323	121
Rajkot	2279	0	2279	2486	17	2469
Bangalore	8371	6779	1592	8371	8636	(265)
Kanpur	4144	18627	(14483)	4144	15390	(11246)
Vadodara	3481	1749	1732	3481	4576	(1095)
Ludhiana	1202	5978	(4776)	1202	8315	(7113)
Total	**66269**	**36131**	**30138**	**59837**	**45226**	**14611**

During the difficult years of 1995-98, most of the affected exchanges decided to consolidate themselves and tried to carve a business model which gave them National presence and structure, caused optimum utilisation of the existing infrastructure, eliminated duplication of cost and ensured centralised development of all future market segments. This business model was given the shape of Inter-connected Stock Exchange of India Limited by 15 stock exchanges of the country in the year 1997 and it was made operational in the year 1999 after receiving the clearance of Securities and Exchange Board of India in late 1998. ISE was on its take-off stage and before this could materialise, SEBI took yet another far-reaching decision of permitting a stock exchange to float a subsidiary and take membership of a larger exchange. It was initially thought that this decision would affect the ISE market, however, it actually proved to be one of the strongest reason for ISE to function and provide the members of the smaller exchanges a yet another market to trade. In effect, what the traders of the RSE's were doing informally at a high cost and risk directly through the brokers of NSE and BSE, was now possible at a much lower cost and risk through the subsidiary. We need to study the financial position of most of the RSE's, to appreciate the future of RSE's and the role that ISE can play in securing their future.

The investment required in the stock exchanges is becoming so large that it is difficult for the exchanges to provide all the future segments through the resources available from internal accruals or from sale of membership. Therefore, more and more exchanges internationally have resorted to demutualisation of the exchange so that necessary resources are generated for public and also to create a more independent corporate structure. The credibility of such an independent system is much more than a closely held company owned by the end user. The table below indicates the pressure on resources of the exchanges participating in by Interconnected Stock Exchange of India Ltd. (ISE), namely, Bangalore, Bhubaneshwar, Cochin, Chennai, Coimbatore, Guwahati, Hyderabad, Indore, Jaipur, Kanpur, Ludhiana, Mangalore, Magadh, Rajkot and Vadodara.

Financial Position of RSEs

Item	95-96	96-97	97-98
INCOME			
Listing Fees	737.72	980.35	1199.03
Fines & Penalties	52.21	35.28	25.56
Subscription	230.89	192.74	157.30
Service Charges	47.24	92.26	183.80
Interest	1461.33	1267.80	850.79
Other Income	804.84	512.84	381.37
Total Income	**3334.23**	**3081.27**	**2797.85**
EXPENDITURE			
Salaries	472.20	546.43	582.73
Stationary	93.57	72.61	52.81
Rent68.03	63.95	42.10	
Computer Maintenance	61.82	68.15	103.44
Travelling	47.96	54.87	57.66
Others	628.69	884.38	877.37
Total Expenditure	**1372.27**	**1690.39**	**1716.11**
Gross Profit	**1961.96**	**1390.88**	**1081.74**
Depreciation	288.13	698.41	1250.43
Net Profit	**1673.83**	**692.47**	**-168.69**

(Source : Annual Reports of the participating exchanges)

It will be clear from the above table that the pressure of low resources on the exchanges is very severe and it is only going to increase as the listing fees are going down and the investment required in technology is going up. Besides, the recurring cost are also going up due to high cost of employing technical professionals and the cost associated with computer maintenance. Since the traditional resources of listing fees are drying up, transaction charges and fixed charges on members are the next logical sources of revenue. Thus, on one hand the competition is increasing thereby, lowering, the income of traders and on the other hand the operations are becoming more expenses with time. Consolidation as conceived by Interconnected Stock Exchange of India Ltd. (ISE) seems to be the most logical method of coexistence for exchanges and also for the traders.

The future of small exchanges in the capital market depends now on competitive pressure on services, liquidity, financial strength of exchanges to provide new segment and price at which these services are provided. In such a scenario, we could see following changes and the meaningful role that ISE is expected to play.

1. The traditional concept of the exchange and its brokers is being challenged by abolition of territorial limit, arrival of banks in securities trading, entry of global players, new entrants from related lines of business, internet, etc. Newer methods of sustaining competition, like, strategic alliances, franchises, merges, etc. are also creating new model of co-existence. However, better reach and client base with low cost of operations will enable ISE and the traders of the participating exchanges and dealers of ISE to face competition better with ISE and ISE Securities and Services (ISS)), a subsidiary of ISE, which has taken membership of NSE. ISE and ISS are correctly positioned for such a future scenario. We expect that it would ensure the profitable co-existence of all the participating exchanges.
2. Capital intensiveness of business will push stock exchanges and support institutions to consolidate, privatise, demutualise and globalise. ISE and ISS is an effort towards such consolidation and co-existence of exchanges and their brokers and also for retaining their cost competitiveness with economies of scale.
3. The markets will see new institutional intermediaries and banks will play a more active role in the market, both as an intermediary and also as provider of capital. Entry of banks in the market will improve the availability of funds for trading due to enhanced familiarity of banks towards lending. ISE would retain the advantage of personalised service, operational flexibility, low cost and educational and investment advisory support that may be given by the traders and dealers of ISE to its investors.
4. The retail investor population would grow both as indirect investors using mutual funds and also as direct investors using the various capital market segments. This increase will come with improvement in the penetration of the market

due to internet, expansion of traders and also due to newer segment available for different classes of investors, like, derivative, debt, equities, etc. Besides, the improvement in the safety of the market (due to demat trading, SGF, margins, etc.) and availability of more traders and dealers to trade at very competitive rates will further widen the interest of the investors in the market. **ISE, through its large and low cost distribution network, will emerge as dependable channel for distribution of diverse financial products to the investors.**

5. There will be new class of players called day traders who would be self employed professionals pursuing trading as a career as seen internationally. This class would have low entry cost barriers and they would add more to the volume of trading merely by doing intra-day trading within a single market or arbitrage between multiple markets. ISE is well positioned to attract such intermediaries directly or as sub-brokers due to its low entry cost at Rs. 5 lakh wherein a trader gets access to NSE and ISE apart from other premier exchanges that it is proposing to provide access to.
6. The banks which will come into the market as intermediaries will add to the competition, however, it may not be directly faced by small traders and dealers as the service levels and flexibility required in this industry may not encourage many active investors to operate through banks. Since the banks have multiple products to offer to the investors, they can cross subsidise the trading as they are getting deposits, float money, lending opportunity, etc., however, it may need to be seen that how much of it would actually result in lowering of cost as the administrative cost of banks are significantly higher than brokers. Apart from banks, this kind of competition will also come from information vendors, DP's, portals, etc. However, the small traders will still be required for servicing the small retail investors who will still need personal service and education. It may be useful for small traders and dealers to consolidate, get into strategic alliance and corporatise to enhance their capital and credibility.
7. In most of the emerging markets, the development of the capital market was triggered by the disinvestment of the public sector enterprise. We have to still see large amount of privatisation and that too preferably at a discount so as to create necessary interest amongst the investors. It indicates that we will see additional growth in investing population which will give further impetus to the market once the Government begins privatisation in large quantum.
8. Globalisation has changed the pace of reforms and therefore the institutional structure of all the capital market institutions and intermediaries has to adapt themselves very fast to the changes taking place in the rest of the world. We are now witnessing consolidation of stock exchanges and other intermediaries across the globe and also about their plans to expand to all the countries in the world. In effect Nasdaq has already reached Honk Kong, Japan, Europe and it plans to be in all the countries in the world within five years. We are also witnessing the merger of London Stock Exchange and the stock exchange of Germany. Australia witnessed merger of their exchanges into a single exchange as early as 1987. Amidst this scenario, the strategy for future development of Indian exchanges and intermediaries needs to be reviewed. ISE is a response towards these challenges experienced worldwide and it has a significant role to play in the future.
9. It is seen in all the developed markets that the investors population is almost 50 per cent of the total adult population where as in India the investors population has been calculated between 20 to 50 million by different surveys which works our to merely 4 to 10 % of the adult Indian population. In case it has to grow to the same level as in the developed countries than we can easily expect significant increase in market size. Most of this increase will have to come from small towns and cities which are not covered into the ambit of trading currently. This fact is also corroborated from the fact that in India the total number of bank accounts with different banks in India is currently 400 million and, therefore, even if we assume that 50 per cent of these are corporate accounts, still we can easily assume that there are several individuals who are confident of operating an account and would some day start saving in capital market also with convenience of electronic and paperless trading. Another fact which indicates the potential of small cities is that 50 per cent of the total amount of trading in BSE and NSE is accounted by centers other than Mumbai. We, at ISE, are therefore very confident that there is a very large potential for growth in this industry and ISE along with the ISS facility is the appropriate mix for success.

Conclusion :

It is clear that the potential of the market for growth is very large. It is also clear that the competition and capital requirement will increase with time. It is also reasonable to assume that global competition is not too distant an event and that the technology will permit seamless expansion at low cost. This scenario indicates that the market will gradually favour the customer more, however, it will also increase the demand for this service significantly and the stock exchanges have very good potential for growth.

Considering these developments, ISE has been promoted as an exchange by 15 Regional Stock Exchanges of the Country. It has been in operation since February, 1999. The Exchange currently has over 350 traders registered on ISE from an over all potential of 4500 traders who are the brokers of the promoting exchanges and it also has over 500 dealers who have been inducted directly under ISE from across the country (over 60 cities) with a large group from Mumbai, Delhi, Calcutta and Chennai so that the potential of all the promising centers can be tapped. Its operations are highly decentralised with support offices in over 18 cities. It enables its traders and dealers across the country to trade with one another through the trading, clearing and settlement system of ISE. These traders and dealers of ISE can now also trade on NSE through its wholly owned subsidiary ISS which has taken membership of NSE. The relevance of ISE has improved even further with this additional service.

It is expected that ISE will become the largest hub for retail investors and small capital companies. Due to its constitution and operational methodology of optimising on the existing infrastructure, it is positioned to be the cheapest trading environment with national credibility being a national-level exchange. ISE has always looked at good corporate governance practices with the interest of investors as prime and, therefore, it has a public representative as its Chairman. Shri M. R. Mayya, who has been instrumental in conceptualising this concept in 1996 and is now also the Chairman of ISE.