Indian Securities Market – Looking Ahead

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1. Introduction

1.1 After the Taj Mahal, globally the most lasting visual about India is that of the building of BSE – an exchange started under a banyan tree more than 125 years ago around the same time as rest of the world was trying to develop its capital market. The capital market in India has traversed a long distance during this period or more so during the last 15 years. Less than 15 years ago the price, size and timing of an issue was decided by the Government through its Controller of Capital Issues sitting in the Ministry of Finance. Today, more than 9,000 scrips are listed in the stock exchanges and more than 9,000 brokers transact more than 20 lakh transactions per day. The market capitalization is close to Rs. 18 lakh crores and 100% anonymous, order matching, screen based trading takes place in over 400 cities and towns spread over the country. The menu of products offered is also very wide; equity, indices, futures, options – single stock and index based and debt instruments. The risk management systems have withstood the test of time and hardly any other country in the world can boast of a system where 100% trade materializes with a 6 sigma variation on a single day as it happened on may 17, 2004. The market regulator has power comparable to the best in any other domain - including power to search and seize records not only of the intermediaries but also of the listed companies in certain specific cases. The main stock exchange i.e. NSE is demutualised and a law has been passed for compulsory demutualisation of other stock exchanges.

1.2 While the last 15 years have seen these major developments and initiatives this period has also seen tumultuous times at frequent intervals. The Harshad Mehta scam underlined the lacunae in regulatory oversight in trading of Government securities and the vulnerability of the banking system to the developments in the securities market. Mid 1990s saw number of instances of corporates raising money at fancy prices and committing the vanishing act. 2000-01 underlined the vulnerability of the system to concerted market manipulation, misuse of tax treaties, round tripping, vulnerability of a major financial institution to the manipulation by scamsters, inadequate regulation, lapses in supervision, un-covered inter-regulatory space and insufficient legal powers.

2. Future Directions

The first generation of reforms so far has seen the underlying guiding principle to be competition, loosening of Government control, autonomy and enhanced supervision. Looking ahead, the objective of a financial system should be to build an architecture which is robust and can support high economic growth. It should be integrated with global markets, should be deep, liquid, offer full product range and broad participation. It should have enough safeguards so that the regulatory and supervisory capacity is globally benchmarked. According to an estimate made in the Ministry of Finance more than 100% increase in investment is required between 2003-04 to 2008-09 from approx. Rs.7,25,000 crores to approximately Rs.15,00,000 crores if a GDP growth rate of 7.5% and a 5% increase in the investment – GDP ratio from 26.3% in 2003-04 to 31.3% in 2008-09 is assumed. Whether these resources are mobilized domestically or from abroad an efficient and well-regulated financial market – more so the securities market, is the primary requirement. There are large number of issues concerning the securities market as we look ahead, but for the sake of a focused discussion, this paper will concentrate in the following areas – (i) Architecture; (ii) Market Penetration; (iii) Products range; and (iv) Regulation.

3. Architecture

3.1 Consolidation of Stock Exchanges

Consolidations of stock exchanges are the trend, which the old powerhouses of the financial world can no longer afford to ignore. From Tokyo to New York and London to Chicago the driving forces of speed, economy and transparency in market transactions are finally having their impact. The MIT Electrical Engineer who took over the reins of NYSE has surprised the financial community across the world by his bold decision to corporatise and also to grow inorganically through mergers with a rival. The merger of NYSE with Archipelago Holdings – an electronic trading firm is not a culmination but a further addition in the growing global trend of consolidation. The pressure of competition is forcing NASDAQ to acquire a competitor i.e. INSTINET Inc. In Europe the DOESCHE BÕURSE AG and the stock exchange in Frankfurt have acquired the Eurex derivative exchange and another one in Chicago. The EURONEXT, Amsterdam bought LIFFE (London International Financial Futures and Options Exchange) and 4 other stock exchanges in Europe. The Finnish and Swedish Stock Exchanges merged to create OMX-AB and also acquired the Danish Exchange. The competition between EURONEXT and DOSCHE BÕURSE AG to buy out London Stock Exchange is an indicator of the direction in which the move for consolidation is going

Besides, from USA to Europe exchanges are shedding their pride in the huge trading floors having open out-cry system and are going towards a system where trades will be electronically matched for a large number of customers.

3.2 Alternative Trading System

Another important development which is providing a competition and challenge to the very existence of exchanges is the trend towards Alternate Trading Systems (ATSs). Without being regulated as an exchange the ATS operates an automated system that brings together buying and selling interests in a way that results in an irrecoverable contract. Rules are set by system's operators based on private-law contracts. There is neither an admission procedure for securities nor a market supervisory authority for ATSs like bulletin boards, crossing systems, market maker systems, order driven systems and hit and take execution. These are perceived to provide lower costs, speed of execution, extended and after-hour trading, access to multiple markets worldwide and provide customized services. Demands for competitive neutrality between stock exchanges and ATSs have been substantially met in the European Union's Markets in Financial Instruments Direction (MiFID) providing for "same regulations for same functions". In the USA the National Market System (NMS) Regulation proposed by SEC could lead to shift in the competitive position of exchanges and ATSs. The writing on the wall is clear that large funds – especially hedge funds, which conduct frequent trading, cannot afford to pay 5-7 times is a non-electronic trading platform.

3.3 BSE or NSE

With our aspiration to acquire larger share in international trade, with manufacturing base being created directly for exports, with services becoming dominant component of GDP, with growing integration with global economy and external sector becoming more and more comfortable it can only be expected that the trend will be towards lesser controls on the capital account. Both BSE and NSE have to be ready to face the challenge and also to leverage their competitive advantages. Time for a second look at their costs and systems as well as the business model has come. When the very existence of exchanges is under challenge from alternative systems and when cross-border alliances/mergers are the order of the day, can they survive in the long run doing domestic equity business alone ? A strategy for their international visibility and presence will have to be developed. They can, for example, spin off on IT business and through it offer IT services to other domestic and international users or leverage bilateral/multilateral treaties to have their presence abroad. Domestically, ways have to be found – both by the exchanges and the regulator, to encourage active trading in new products. The number of participants and customers has to grow fast. India does not live only in 400 cities and towns – where the exchanges have stagnated for the last 5 years after an early faster growth. Volumes can help reduce costs which are going to be the key differentiation in the future competitive environment. Besides, in order to generate confidence and to unlock their true potential, BSE must complete its demutualisation real fast and both NSE and BSE must plan for getting listed in the near future.

3.4 RSEs

The question regarding the business model of the RSEs or their existence is even more serious. A recent study by the ADB has highlighted that the RSEs did no longer serve any economic purpose and there is no business justification for their existence – even as a specialized stock exchange for small cap companies. The lifeline provided by Government's notification of compulsory listing in regional stock exchanges has been withdrawn and the presence of broker terminals across the country has removed the advantage of geographical location for these RSEs. Various alternatives such as forming a confederation of all the RSEs -either at the national level or at the regional level, consolidation with BSE/NSE or reverse merger of all RSEs into their subsidiaries and their subsequent partnership or merger with BSE/NSE will have to be explored. Linked to the issue of RSEs is the issue of brokers and sub-brokers in the RSEs. A way forward has to be found in the near future for consolidation of the small brokers into strong brokerage firms and facilitating their acquiring trading rights in BSE or NSE in a transparent and fair manner. Various countries have gone through different processes of amalgamation of the stock exchanges. The future of RSEs need to be decided in order to harness their existing strengths and resources and also to encourage issuers and investors at centers having potential to do so at reasonable cost and ease.

4. Coverage

4.1 Investor base

We cannot forever bask in the glory that NSE/BSE broker terminals are in existence in over 400 centres. As on 30.6.2005 the total number of accounts in NSDL were about 67 lakhs and in CDSL 9 lakhs. Even assuming that none of these accounts are multiple, the base of active investors in a country of the size of over 100 crore cannot be as little as 74 lakhs. The erstwhile UTI had an investor base of more than 2 crores. It is likely that many investors are only interested in holding their securities and not in trading and therefore have not cared to open demat accounts. Even then the issue remains that the reach of securities market in the small towns, rural areas and even amongst less educated, less-savvy population in the metros is quite weak. The total working force in the country is over 36 crores out of which at least 10% are in the organized sector and remaining 2% in the Government sector making the total to 4.3 crores. The EPFO has more than 4 crore accounts out of which discounting for multiple accounts at least 50% i.e. 2 crore accounts are of active workers. There is no reason why persons active in the securities market should be less than this number.

4.2 The issue of penetration in the market can also be looked at from the point of view of the resources need for small and medium enterprises. World over 29 dedicated small markets have been identified ranging from London's AIM (market cap US $ 3 billion) to Helsinki (less than US $ 1 billion). Some of the common factors for low liquidity in small cap stocks are lack of media coverage, lack of broker research and institutional interest, low dividend yield and volatility of the stock exchanges. Besides, these stocks have often got small free float and often there are no market makers. While the Indonext initiative by BSE, following the amendment of Securities Contract Regulation Act in 2004, is a step in the right direction, going ahead, the approach has to be dovetailed with the future of the RSEs, consolidation of brokers and the need for NSE also coming out with a similar platform. Credit rating of SMEs and support from institutions, especially charged with the growth of the SME sector, such as SIDBI will also be required. Going ahead, this would be an important challenge and agenda for the growth of the capital market in the next 5-10 years.

4.3 Both Government and SEBI have to create the environment to encourage people to come to the market to invest in an instrument of their choice and which they understand well. 30 MFs regulated by SEBI have over the whole year of 2004-05 added only Rs.7000 crores of assets under their management in equity. During the same period, foreign institutional investors brought in over Rs.45,000 crores in equity in the Indian market. There are also concerns regarding opacity in costs and fees. The whole business model and practice of the MF industry needs a serious revamp if the basic purpose of placing the money of a retail customer in the hands of an informed fund manager is to be met. Similarly, the DPs system has failed to address the concerns of retail investors.

4.4 The task of educating the investor is the most important and challenging task for the future growth of the capital market. Attempts to provide investor awareness have been haphazard and non-comprehensive. The idea of continuous, comprehensive education of the investor with funding both by the government as well as by the industry in a sustained manner can provide a solution to the problem of aversion to the market. Expert financial advisers providing objective advise based on fees and who are regulated regarding ethics and professional conduct by a regulator can go a long-way in helping in this direction. Ombudsmen which are easily approachable to redress grievances emanating in remote places is also a felt need.

5. Products Range

5.1 A look at the major indicators of the Indian capital market provides a very optimistic picture; as can be seen from Table – 1:

Table – 1

(Rs. in crores)

Sl. No.	Item Name	2003-04	2004-05	Variation
1.	Money raised from the primary market	23,272	28,256	21.41%
2.	Total Turnover			
	-Cash Segment	16,20,497	16,66,896	2.86%
	-Derivative Segment	21,43,101	25,63,165	19.6%
3.	Market Capitalisation			
	-BSE	12,01,207	16,98,428	41.39%
	-NSE	11,20,976	15,85,585	41.44%
4.	Indices			
	-BSE Sensex (Average)	4492	5741	27.8%
	-Sensex (Year end)	5591	6483	16.13%
	-NIFTY (Average)	1428	1806	26.47%
	-NIFTY (Year end)	1772	1806	14.88%
5.	FII net investments	US$ 9.95 bln	US$ 10.172 bln	2.23%

Source: SEBI Annual Report

5.2 While the turnover and the market capitalization have improved impressively, the fact remains that NSE and BSE accounted for more than 95% of total turnover in 2004-05. As many as 16 stock exchanged reported nil transactions and 5 more had transactions of less than 0.3% of the total turnover. Ten top cities from Mumbai to Pune accounted for 91 % of the total turnover – with Mumbai accounting for 56% and Delhi 11%. Although BSE had more than 5,500 listed companies, number of shares, which traded for more than 100 days in BSE, was only 2,368. The volumes in derivatives at approximately twice the volume in the cash segment (NSE 223% of cash market in 2004-05) is much below the level in developed markets. Besides, almost the entire volume is in NSE. Out of Rs.25,63,765 crores NSE accounts for Rs.25,47,053 crores and BSE a meagre Rs.16,112 crores. Looking into the products, the distribution is even more skewed, as can be seen from Table – 2 :

Table – 2

Product-wise share in turn-over during 2004-05

Product	Percentage
1. Single Stock Futures	57%
2. Index Futures	31%
3. Stock options	7%
4. Index options	5%

Source : SEBI Annual Report

Not only are the volumes in options and in index futures sluggish, institutional presence - including FIIs, in this area is marginal. For e.g. the participation by FIIs and institutions at less than 2% is rather intriguing because institutions with large presence in the cash segment and having a research and risk management system would be expected in normal course to be more active in the derivative segment.

5.3 Debt Market

5.3.1 If our corporates are to be globally competitive the Indian capital market cannot afford to remain a pre-dominantly equity market. The trading in debt market is marked by absence of liquidity and dominance of Government securities. The net traded value in the WDM segment of NSE declined from approx. Rs.13 lakh crores in 2003-04 to less than Rs. 9 lakhs crores in 2004-05. The share of different products was :

Table No. 3

Government debt securities	81.69%
Treasury Bills	14.07%
PSU Bonds	2.01%
Others	2.23%

Source : SEBI Annual Report

5.3.2 Looking at the corporate debt segment the position is rather disappointing. Debt raised by the corporate sector in the last four years is given in Table – 4 :

Table – 4

(Rs. in crores)

Year	Public Issue	Private Placement	Total	% of pvt.Placement In total debt
2001-02	5,341	45,427	50,768	89.47
2002-03	4,693	48,424	53,117	91.16
2003-06	4,324	48,428	52,752	91.80
2004-05	4,095	55,384	59,479	93.12

(Source : Prime Database)

It is apparent that private placement provides the predominant part of corporate finance. Financial sector accounted for three fourth of the money raised pushing other corporates way behind. While private placement may provide ease for both issuers and the institutional investors, secondary market is extremely illiquid and market disclosure is minimal. Attempts made in the last 2 year to ensure disclosures with a view to remove regulatory arbitrage have not been successful in reviving the public issue of debts. The participation by retail is almost non-existent and exit is difficult. Besides, provisions such as allowing corporates to raise fixed deposits directly from the general public are also proving a deterrent.

5.3.3 Structured Products

Besides plain vanilla products efforts are also required to facilitate trading of securitised and structured products. Securitisation took off as an asset class in the mid-80s in the USA but by the end of 2004 it had grown to US$ 23 trillion, which is 31% of the US Bond market. In Europe the size has grown to US $ 500 billion by the end of 2003. In the developing countries securitised debt market has crossed US $ 36 billion at the end of 1999 after it first started in Mexico in 1987. In India, the issuance in the year 2003-04 have been in the range of Rs.13,000 crores out of which more than 50% was in Asset Backed Securities (ABS). Structured instruments having a (i) pool of assets, (ii) tranching of liabilities and (iii) de-linking of credit risk from the originator have grown into a huge market. Corporates world over are raising increasingly higher funds through collateralized debt obligations (CDOs) having different levels of security in payments backed by cash flows of underlying debt portfolio. There is need for an effective legal and regulatory framework for the growth of market for securitisation of mortgages, credit cards, auto and consumer loans, student loans, export receivables, off-shore remittances, corporate debt and newer areas such as telephone receivables, tax receivables etc. While there is a huge pent-up demand for mortgaged backed securities (MBS), requisite legal provision has to be put in place. In the budget 2005 an announcement was made to amend the Securities Contract (Regulation) Act to provide for trading of securitised debt. The same needs to be enacted and regulatory framework put in place at the earliest.

5.4 Pension Funds

Another important avenue to provide new products is the Pension Fund. A defined contributory pension system at least for those who are willing to save during their working life is inevitable. If the same is not facilitated and regulatory system is not put in place, other financial service providers will occupy the space – may be by putting the old-age income security of the customers at risk. It is not emperically established that pension assets are a pre-requisite for the growth of the capital market, and this premise is certainly not true for India. But the fact remains that a combination of a good capital market and pension funds provides a virtuous cycle. In India, the Central Government has already decided to introduce defined contribution pension for its new employees. 10 State Governments have also decided to join. A recent survey on savings behaviours conducted by AN Nelson and ORG-Marg has estimated that over 2 crore persons in the age group of 35-50 and having disposable surplus are willing to join the defined contribution pension scheme knowing fully well that funds will be locked in for decades and that there is no guarantee. Issues such as eligibility and the number of fund managers, their investment guidelines, redressal of investor grievances, transparency in their operations etc. have to be designed with care so that this sector can play a very big role in the growth and accumulation of life long savings.

6. Regulator

6.1 The JPC on stock market scam has, inter-alia, underlined the issue of inter-regulatory overlap and inter-regulatory vacuum. While SEBI Act has been amended, the Company Act is yet to be amended. The JPC also evaluated the option, of a super-regulator like the FSA but preferred a mechanism of effective coordination amongst the regulators. While a mechanism through the high level coordination committee of regulators exists, more and more co-operation at the operational level amongst the regulators is required if the integrity of the entire financial market has to be maintained. Different countries have planned different models. On one hand there is FSA and on the other hand there are multiple examples of different regulators for different sectors. Another model is in Australia - where there is a separate regulatory authority for prudential regulations (APRA) and separate regulator for customer related issues (ASCI) for all the intermediaries and service providers. New activities in the economy are providing new challenges for the regulators. The growth of the pension market will require separate regulator – if for no other reason than to provide the comfort to the investors placing their life long savings for over 3 decades, that their money is being well regulated. Another area requiring urgent attention is the commodities futures market. An announcement was made in Budget 2004 that Government would be working towards the integration of the commodity futures market and the securities market. The setting up of national level commodity exchanges has led to rapid growth in volumes. The commodities market has strong inter-dependence with the financial sector; especially banks and the securities market. It is extremely important to ensure a very robust and well-designed mechanism of inter-regulatory coordination.

6.2 New activities in the economy are providing new challenges for regulators. The speed and volumes with which funds can flow across borders in the securities market can pose important challenges for the monetary authorities. Sophisticated hedging and derivative instruments are already a major challenge for the banking, securities and currency regulators. The language and algorithm being used in CDOs – CDOs squared and CDOs cubed, for example, have tested the regulatory capacity to the extremes even in the developed markets. The primary requirement for the growth of securities market is to avoid any systemic misconduct and to ensure the general public about the vigil and oversight of the regulators. In order to meet this requirement, strengthening and upgradation of regulatory capacity is a must. Issues such as compensation packages cannot be avoided any further and a mechanism need to be created for horizontal exchanges between regulators, Government and the market. For the long-term and sustained growth of the market regulators must remain ahead of the participants and not lag behind.

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