DR.K.P.KRISHNAN
Joint Secretary (Capital Markets)
Ministry of Finance
Government of India

THE INDIAN SECURITIES MARKET - TEN YEARS HENCE

"We cannot predict the future, but we can invent it." —Dandridge M. Cole

The twenty first century is a time when there is optimism all around in India. India's GDP in terms of USD exchange-rate is over $1 trillion. The economy has posted an average growth rate of more than 7% in the decade since 1997, reducing poverty by about 10 percentage points. India achieved 8.5% GDP growth in 2006, and again in 2007. The Stock markets are doing well. The market capitalisation stands at Rs. 49, 55,444 crore on the BSE. In terms of market capitalization, the Indian securities market is the sixth largest in the Asia Pacific region after Japan, China, Hong Kong, Australia, and Korea. According to Global Stock Markets Fact Book 2007, India ranked 15th in the world on market capitalisation as at the end of December 2006. In terms of number of listed domestic companies, India, ranked second only to United States and way ahead of more mature markets like United Kingdom and Germany.

Historically, while fortunes were made and fortunes were lost on the stock exchange, the securities market was regarded as somewhat removed from and peripheral to the real economy. That position remained until the economic reforms were initiated in 1991. Since India embraced globalization in 1991, there have been occupational groups who have lost their jobs, firms that have gone bankrupt and investors who have burnt their fingers. However, the gainers of India's growth story have outnumbered the losers. In fact, the losers have been those who have not been able to change with the times or those who were earlier enjoying their power owing not to their own hard work but due to the wealth accumulated by their forefathers. In a system of free markets all entities have equal opportunities. The successful are those who understand the system, have an open and curious mind along with a passion for change and "keeping up with the times".

The reform of the securities market began with the appointment of a market regulator. Soon afterwards, the Securities and Exchange Board of India Act 1992 was passed. Over the years, the regulator acquired more experience and more teeth. Through this period, the stock market also witnessed scams. Nevertheless, today, informed public opinion in India regards the securities market as a vital part of the market economy and a key instrument in mobilising resources for investment.

With time this opinion is likely to get strengthened with the belief that financial literacy needs to be embedded in our culture as general hygiene is. An apparent paradox in India today is the high rate of savings along with reasonably modern and efficient financial markets. However, there is very low allocation of household savings to financial assets. Only half of the Gross Domestic Savings goes into financial savings and most of the financial savings goes to fixed income bearing instruments. With the financial media – both electronic and print devoting a lot of time and space to the spread of financial education, it is hoped that in the next decade the average educated Indian would be able to make informed judgements regarding the current and future use and management of money. The financially aware parent would want her children to be money-wise as well. There is talk about introduction of a paper on personal finance in the school curriculum at the +2 level. If this happens increased financial literacy would inter-alia bring about higher participation in the markets.

The increasing interest in markets, both domestic and overseas, is going to make capital fully mobile. Once restrictions on capital mobility are removed, prices of assets across the globe will converge except for transaction costs of moving capital. The differences in the latter would still provide arbitrage opportunities to players but the factor price equalization theorem is likely to prevail.

Increasing availability of capital is a window of hope for the Small and Medium Enterprises (SMEs) . SMEs in India have traditionally relied on debt financing from banks and non-bank financial institutions. In order to develop the equity market for SMEs, SEBI has decided to create a separate exchange for the SMEs. It has decided that, to begin with there should be a single exchange for the SME sector for around 2-3 years to enable successful development of the market for SMEs. By the next decade one can visualize a separate exchange for the SMEs which is as successful as London's Alternative Investment's Market where not only Indian but also foreign SME players flock to raise capital.

The above can be facilitated by the use of technology which has completely changed the architecture of securities transactions. Technology is expected to spur globalization by linking Indian markets with those abroad. Today it has made the trading platform accessible to clients through the internet and mobile devices. It would continue to play a much bigger role in the days to come in the execution of trades and monitoring of positions in the market. Since technology as a tool is a product that can be acquired, it would enable exchanges to directly map the ultimate clients (direct market access) having a distinct identification number, which can be linked to their bank and the depository accounts, making brokers redundant. Soon, No broker would be required to trade on behalf of a client and the client will have direct access.

The HPEC report on making Mumbai an International Financial Centre (IFC) envisages a first phase (2007-2012) where Mumbai connects India's financial system to the world's financial markets. This will mimic what IFCs like Frankfurt or Tokyo do for their respective national economies. In the second phase (2012-2020), the HPEC recommends that Mumbai must develop the capacity to join London, New York and Singapore as one of the premiere IFCs of the world. For this to happen it is desirable that the Indian financial system become more open and outward-oriented in order to enhance its technology, efficiency, productivity, competitiveness and quality. It is also expected that the barriers constructed between different segments of the financial market i.e. banking, insurance, capital markets, asset management activities, and derivative markets for regulatory purpose are dismantled and the following missing markets be set up (i) bond market; (ii) spot currency trading market; and (iii) a broad derivatives markets that includes exchange traded as well as tailored derivatives for the management of currency, interest rate and credit default risk.

Traditionally, businesses were clearly differentiated; banks offered payment services, insurance companies offered risk sharing and securities companies offered allocation of resources. This resulted in separation of supervisory structures along business lines. The economies of scale and economies of scope coupled with financial deregulations have ushered in an era of mergers and acquisitions, leading to emergence of universal financial power houses. This has the repercussion of the risk of one activity / segment spilling over to the other activities / segments of the markets. If there are different regulators for different activities within the domestic jurisdiction, there is a potential problem of shifting responsibilities among the regulators, particularly during times of crisis.

Further, while business is borderless, regulation is not. There is a growing mismatch between the limited authority of national regulators and global reach of financial intermediaries. This increases the chances of systemic risks in one country spilling over to other countries. The regulators, domestic and overseas, need to co-operate more frequently and intensely than ever before and that too at multiple levels. Then there is also the issue too large or too interconnected to fail.

Investors, issuers and intermediaries increasingly see the benefits of internationalization and the regulators see only one global market. With the investor in country A, the broker in country B, the exchange in country C and the issuer in country D, the legal basis for any contracts and legal disputes may be ambiguous. The different national regulators may avoid taking responsibility. The differences in legal background and regulatory tradition complicate matters further. Harmonising the market regulations would greatly simplify the problems and reduce the compliance costs on participants who do not have to comply with different regulations in each country. Similarly harmonisation in accounting standards would reduce information cost of investing and increase international investments. But is such harmonization possible and desirable? Given the differences in legal system and regulatory tradition, such harmonization may be difficult. Besides, it would reduce competition between different regulatory regimes. In the non-harmonised regulatory system, one can compare and learn how different regulatory systems handle different problems and every jurisdiction learns from another. There is a need to strike a balance. Further, the concern of an investor has to be addressed. He has to be ensured that international investors enjoy at least the same, if not better, rights and guarantees as local investors do and are assured of non-discretionary treatment from the state.

There will always be a debate on the question of appropriate level of regulation. Whether regulation is excessive or indulgent is a matter of judgement. A successful regulator will strike the right balance. Besides, the level of regulation is directly determined by the conduct of market participants. It can be reduced drastically if the market participants so wish.

Indian securities market has earned respect in the comity of securities markets in the world but it constantly needs to change and develop to face new regulatory challenges. First of all, globalisation is no more a choice, but an inevitable reality for which every country should be prepared. Inflow and outflow of capital would continue to pose serious problems. One can expect high degree of volatility in the equity market, forex market and debt market irrespective of the level of capital account convertibility. Secondly, there is likely to be greater uncertainty with respect to movement of international interest rates and exchange rates. Thirdly, there is a potential threat to financial stability of the emerging market economies (EMEs) arising out of disorderly adjustment of international macro-economic imbalances, particularly with respect to twin deficits (fiscal deficit and external current account deficit) in the US. Fourthly, inflation expectation looms large in most part of the world. As the above challenges are originating from abroad, we have little control over them. Nevertheless, we have to strengthen our risk management system. India's governance standards and regulatory framework have to be improved so that its in a position to convert challenges into opportunities.

In the future, it is expected that the increasing interdependence across jurisdictions is going to lead to the creation of two markets- first, the Global market which can be supervised by a super international regulator, perhaps even an affiliate of United Nations Organization, with the assistance of domestic regulators and second, the Local market which can be supervised by domestic regulators. Hence two sets of laws - one for global participants, issues, markets and the other for local participants, markets, issues would be needed.

Regulations require transparency which comes from disclosures made by market participants. Disclosures by intermediaries are best if they are voluntary and/or mandated by Self Regulatory Organisations (SROs). The SROs are expected to supervise the securities companies, monitor the management of securities companies. In India, the formation of an SRO is a task yet to be completed. But once they are set up, they would help reduce SEBI's regulatory burden and enhance the fair and smooth trading in securities by strictly enforcing self-regulatory disciplinary action. However, in India, there is a danger of people being soft on others of their kind. A super SRO may get into a mutual back-scratching exercise because everyone may feel vulnerable to action at some point and no one wants to make enemies. A proper policing system is essential so that the above mentioned sensitivities do not come into play.

In order to track the movement of funds and to enhance transparency as well as provide regulatory ease PAN was made the sole identification number for all transactions in securities market. This is also been an investor friendly measure as he does not have to maintain different identification numbers for different kinds of transactions/different segments in financial markets. This year's budget seeks to extend the requirement of PAN to all transactions in the financial market. With markets becoming more and more sophisticated with time, this number is expected to play a bigger role like that of the Social Security Number in USA.

Most developed economies follow the system of principles-based' regulation. Indian financial regulatory regime is often criticized for being rule-based, rigid and inflexible. Rule based regulations make it easier for regulators to enforce compliance by requiring the regulator to make less judgement calls but they are costly. Principle based regulation on the other hand leaves a lot of discretion in the hands of both regulator and regulated and requires a much higher level of responsibility on the part of both. It can help prevent a tendency to micro-manage or over specify on the part of regulators. As the Indian financial markets mature a gradual shift from rule based regulation to principle based regulation seems to be on the cards.

Several measures have been taken in the last 15 years to make the securities market in India better regulated, more efficient and generally safer and several measure will be taken in future to achieve the same objective. One may not beable to predict exactly what happens ten years hence but the direction where India's headed can be ascertained. The scenario is positive. India is amongst the fastest growing economies of the world second only to China. Soon, one will beable to see the jumbo enter the stage along with the dragon.