Indian Growth and Capital Market: Need of Structural Rationalization for Wider Participation

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The Indian capital market has seen significant changes in the regulatory and structural paradigm since 1991 but it has not matched with the commensurate changes in the products profile, range of services, capital mobilization, cost of raising capital, etc. This looks more prominent when compared with the developments in other emerging markets including China. India has just 19 million direct users of capital market as seen from the Depository accounts whereas China has 190 million users registered in their depository. Broad based market is always a national theme all over the world as more investor means more wealth creation and distribution in society and also better allocation of risk capital.

With the advent of technology, the Capital Market globally has become more technology intensive permitting faster information processing, enabling rapid resource mobilization and increased real capital formation with greater safety due to audit trails and at lower cost. This advancement has forced the policy makers to ensure rationalizing the products, processes and participants for improved integration of capital market with entire financial sector to act as a catalyst for economic growth. Increase in capital market activities stimulates economic growth and economic growth has further attracted higher participation and innovation in capital market. This has been seen in every economy which has eventually reached a status of being a developed nations. It has happened in Europe, US and now it is being witnessed in BRIC nations and other emerging countries in Asia and South America. India has witnessed this for more than a decade now.

India has responded reasonably well to the process transformation observed in global capital market, but has not been able to achieve the synchronized cycle of capital market and economic growth due to factors like, silo based regulatory policy in financial sector, uneven competition within capital market during the growth phase, lower level of investment participation by investors and larger intraday trading psychology prevailing in the market due to cash settled F&O market, banks not providing capital market services except some of the recent instances, etc. Globally, banks have been a big distributor of capital market related services and higher credibility enjoyed by Banks we would have made greater inroad if Banks were increasingly focusing on capital market services. Indian economic growth story has been trusted even by global participants and they are participating either through green field projects or in secondary market (Table 1). Domestically, the Indian economic growth is neither reflected in resource allocation through primary market nor supported by other data on capital market, like, availability of product or service or wider penetration of investing population.

Table 1: FII Investment in India

2004-05	45,881
2005-06	41,467
2006-07	30,841
2007-08	66,179
2008-09	(45,811)
2009-10	142,658
2010-11	146,438

Figures are in Rs Crore (Source: SEBI)

Total IPO raised in during the last five years as compared with GDP and Bank lending to Industry

Table 2: Capital Raised Through Stock Exchanges vs. Economic Growth (in Rs. Crore)

Year	2007-08	2008-09	2009-10	2010-11	2011-12
Number of IPOs	85	21	39	53	10
Capital Raised through IPO	42,595	2,082	24,696	35,559	2,229
Number of FPOs	39	25	34	28	1
Capital Raised through FPO	11,916	12,637	30,359	22,599	4,578
Total Capital Raised through IPO and FPO	54,511	14,719	55,055	58,158	6,807
Private Placement	118,485	173,281	212,635	218,785	32,237
GDP at Current Price	4,986,426	5,582,623	6,550,271	5,298,129	
Non Food Credit by Banks	2,301,901	2,724,691	3,193,077	3,906,480	4,006,719
Capital Raised (IPO, FPO and Private Placement) as % of GDP	3.47%	3.37%	4.09%	5.23%	
Capital Raised (IPO, FPO and Private Placement) as % of non food credit by banks	7.52%	6.90%	8.38%	7.09%	

IPO, FPO, Private placement data for 2011-12 is as on 31st May 2011
Non Food Credit by Banks for 2011-12 is as on 1st July 2011
Source: SEBI, RBI, Economic Survey

This is evident from the fact that in a country with population of more than a billion, having a savings rate of more than 30 percent has merely 1.7 percent residents participating in Indian Capital Market through demat account. A quick comparison of the market participants across major market across the globe, as shown in Table 3, indicates that the capital market participation in India is nearly 20 percent of Internet users and nearly 2.5 percent of mobile users. In the USA, capital market participants accounts for nearly 45 percent of internet users and nearly 37 percent of mobile users. It indicates how the economic growth of a country is reflected in and supported globally by capital market activities, but this synchronized development of market and economic growth is lacking in India and hence the need for the rationalization of policies and processes is desired for stimulating wider capital market participation.

Table 3: Need for Synchronized Growth in India

Parameter	US	UK	China	India	Singapore
GDP (US$ Bn) (2010 Est.)	14,720	2,189	4,750	1,200	267
Population (in Mn) (2010)	300	60	1,300	1,120	5
Market Cap. (US$ Bn) (Apr 2011)	14,722 (NYSE)	4,039 (LSE)	2,926 (SSE)	1,563 (BSE)	681 (SGX)
Gross household savings rate as percentage of disposable income (2008)	4.4%	2.5%	28%	32%	34%
No.of mobile phone connections (in Mn) (2010)	303	80	886	811	6.8
No. of internet users (in Mn.) (2010)	245	51	389	81	5.9
No. of Investors (in Mn) (2011)	110	10	194	19	1.5

Source: www.CIA.gov and Others

The challenges in the capital markets arena have underlined the need for heralding third generation financial sector reforms. One of the daunting challenges that need to be met by the Indian capital markets is expanding the investor base and provides them access to high quality financial services demanding for wider investors' population in line with other major countries.

India has a robust household savings rate, which has grown over recent years to a current level of more than 30 percent. But the channelization of savings is not realized as almost 55 percent of savings is in the form of physical assets, while a large number of corporates and especially SMEs are in need of risk capital. The average annual growth in resources mobilized through primary capital market (Table 4) is nearly 16 percent while the market turnover during the same period of 2004-2011 has grown at an average annual rate of nearly 41 percent. This disparity needs to be rationally synchronized very rapidly.

Table 4: Resource Mobilization from Primary Markets

2004-05	28,256
2005-06	27,382
2006-07	33,508
2007-08	87,029
2008-09	16,220
2009-10	57,551
2010-11	67,609

Rs Crore (Source: SEBI)

The growth and development of small and medium enterprises (SMEs) play a vital role in greater financial inclusion. SMEs contribute greatly to our foreign trade and to employment on a large scale. The much awaited SME stock exchanges should be given due consideration given the potential they have in assisting the entities in raising capital and reducing their excessive dependence on bank lending. This will assist companies of various kinds to raise capital at competitive terms and attract large investors of various types to invest in diverse instruments. This platform may be an extended part of the exchange and will cause new capital raising, new product developments, create new breed of investors, create new breed of funds to capture divergent business opportunities in a rapidly growing market like India. SMEs also have the potential of driving investors from local area where the companies are located towards the capital market.

Despite the growth in market capitalization of listed companies which is more than 130 percent of GDP, the market liquidity and depth have not improved. More than 80 percent of trading is concentrated amongst 5 cities and out of over 6000 listed companies, trading is largely confined to top 100 securities. The average daily turnover in cash market grew two times, nearly Rs.19,000 crores in 2011 from Rs.9,000 crores a decade back (2000-01) when the benchmark SENSEX rose to more than 5 times during the same period. The growth in turnover in secondary market is skewed towards cash settled and speculative instruments as observed in the current market share of various products where the delivered equity constituted merely 2.8 percent compared to non-delivered equity trade of 7.3 percent, futures of 22.2 percent and Options of 67.7 percent as observed during May 2011.

There is huge scope for increasing market efficiency on products, processes and participants through greater competition amongst Exchanges, more number of intermediaries, wider investor base etc. This competitive market will also benefit development of new products - not yet available in the country, like, Bond Market, SME Platform, full range of Interest Rate Derivatives market etc. Globally, the Bond market and Interest Rate Derivatives account for more than 80 percent of the Exchange traded market whereas in India Equity and Equity derivatives account for more than 80 percent of the Exchange traded market. In contrast, the turnover of these globally successful products in India is virtually zero. Some of these successful products may be carefully calibrated and also be introduced into the Indian Capital Market. It is seen that as more product segments develop and as investor population increases, market integration with economic growth also increases which is converted in wider participation and higher liquidity. Indian market exhibits ironic gap of globally successful products, listed in Table 5, despite being one of the largest and rapidly growing economies of the world.

During the last three years, three significant products were introduced to Indian market namely Currency, Mutual Fund trading through exchanges and Interest Rate Futures. Of these three products only Currency product succeeded on three exchanges as against launched on four. Interest rate futures and mutual fund trading did not succeed on either of approved exchanges NSE or BSE. In contrast to capital market, other industry such as telecom, aviation, insurance and banking etc, demonstrated more innovation, better service, greater depth due to greater and healthy competition and it has yielded positive economic output of deeper penetration, greater innovation and lower cost of service. We must allow the same competitive environment within the exchange industry.

Table 5: Absence of Market Products in India vis-à-vis Global Markets

			India	US	UK	Japan	Korea	China	Brazil	Malaysia
Equity	Cash									
	Futures									
	Option									
Debt	Govt									
	Corporate		Very Low							
Index	Futures	Equity								
		Debt	N							
		Others	N							
	Options	Equity								
		Debt	N							
		Others	N							
FX	Futures	Direct						N		
		Cross	N					N		
	Options	Direct	Limited					N		
		Cross	N					N		
Rate	Futures	< 1 Yr	Very Low							
		1 - 10 Yr						N		
		> 10 Yr	N				N	N		N
	Options	< 1 Yr	N					N		N
		1 - 10 Yr	N					N		N
		> 10 Yr	N				N	N		N
ETF										N
ETC			N			N	N	N		N
SWAP			N				N	N		

N Not Available; Available

Other major challenge lies in the concentrated trading pattern, as highlighted earlier, and it can only be altered through spread of market participants geographically as well as across the economic strata of Indian population. The participation in the real capital formation should be the obvious choice of the investors rather just focusing on the fixed interest based investment. On one side this can be achieved through increased awareness and simultaneously tapping the resources through wider distribution network of banking industry. This has also been highlighted in the "Indian Equity Investors Survey 2010" (http://www.mcx-sx.com/IMRB_Survey.pdf) demanding cross selling of financial market products through banking channel. This survey was conducted by MCX Stock Exchange through the Nielsen Company. The same survey also revealed lack of financial literacy as one of the major impediments in spreading financial inclusion.

If capital market products are made available through the banking channel then this would not only enhance indigenous financial capability of the common citizen, but also help in maximizing the investor base, channelizing fund flow from low yielding instruments to growth oriented activities providing higher return and simultaneously creating new sources of income stream for investors and employment opportunity for masses. This would encourage real capital formation helping the entrepreneur with domestic funds and thereby reducing the dependence on foreign capital. If banks can deliver easier and reasonably priced products, then the less financially educated population and the middle and lower income groups would be easily attracted towards the formal financial system.

Greater integration of the financial system is one of the solutions to achieving financial inclusion and accordingly all financial services can be made available to customers under one roof. Convergence of financial services at last mile will create low costs financial services distribution model for all services. Integration of network of banks, exchanges, insurance companies, fund houses and other financial bodies and institutions can facilitate enhanced financial inclusion and the entire value chain in financial sector can benefit from such broad based market. This would facilitate easy criteria for financial agents to cross sell all financial products without handling money. Various market regulators like RBI, SEBI, IRDA, PFRDA and FMC etc should initiate a process towards common criteria for registering these financial agents. SEBI has now decided to expedite their reform which is a step in the right direction. Indian entrepreneurship being at early stage of growth cycle, the promoter concentration in the equity holding is higher. Ongoing Indian growth story is another reason for higher promoter and institutional concentration in the shareholding pattern. According to NSE factbook 2011, promoters hold 57.4 percent while foreign institutional investors hold 10.3 percent whereas mutual funds hold only 2.6 percent and Individual investors hold 11.7 percent in NSE listed companies. Low free float of the companies further create a supply constrain while the economic growth constantly creates demand and hence resulting in the distorted demand – supply equilibrium in the Indian capital market. Though in recent times regulators have initiated steps to increase the free float of listed companies but the results are yet to be realized by the investors. Government could coherently organize a special sale of PSUs to domestic retail population as spread of Equity Mission and financial literacy drive.

Due to low per capita income and service oriented middle class, traditional Indian citizen representing this class is risk averse. These investing classes invest in insurance industry or pension industry due to tax benefits and partly for securing future. However, these classes never had any incentive to invest in capital market. Even small tax incentive for saving in capital market could attract investors into this market and will induce them for financial learning about capital market. Additionally, investment tax incentive up to say Rs. 10,000 in equity of top 200 companies would be helpful to attract more retail participants, will be an inching steps towards the goal of complete financial literacy and financial inclusion.

Keeping the growth and financial participation balanced, need for a wider customer base prompts introduction of new products and services, technology advancements at competitive prices. These benefits can accrue only if competition is fostered lucidly. Competition is encouraged, not only globally, but also in numerous Indian industries fostering service providers to bolster on expanding reach. Contrasting to two national level electronic stock exchanges in India, there are 11 SEC registered national securities exchanges, 2 unregistered exchanges and more importantly around 80 active Alternative Trading systems (which act as deemed exchanges) in United States. There are around thousands of national commercial banks in United States as against hundreds in India. The policies encouraging competitive environment in the US have resulted in nearly 50 percent household holding equity shares. The higher equity ownership by the household represents greater participation and ensures that the benefits of economic growth are directed towards the households without any frictional slippage. The benefit of competition has been witnessed in Indian telecom industry as well which has resulted in almost 70 percent penetration of mobile telecom facilities in Indian mass.

The rationalization of the capital market products, processes and, participants, would enable India to offer globally competitive financial products, benchmark processes and substantially distributed participation from across the country. This will also attract the non-resident high earning Indians to actively participate in Indian capital market. More number of non-speculative participation would further enhance the healthy wealth distribution across the wider investing population by participating directly in to the Indian economic growth. The proposed approach would enable India to achieve the synchronized cycle of balanced capital market and sustainable economic growth.