Broadening of Indian Capital Markets

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'If you want to know how things in Britain are going on, do not study the House of Commons, but watch the London Stock Exchange'. —— Advice by **Bismarck to a German Diplomat** enroute to London.

That been said about London Stock Exchange more than a century ago, when the exchange had been a busy place trading in local financial instruments among the British. However, with diversified participation and instruments, currently the same exchange remains a barometer of economic health of financial markets and hence most of the developed nations themselves.

With healthy growth and increasing base of our population, the challenge before policy planners would be to turn the healthy economic growth trend of the past decade into an economically and socially sustainable phenomenon. Markets, as institutions which enable democratic interplay of economic forces, play a critical role in making economic growth inclusive and sustainable. Capital markets are no exception to it. In a monetized economy, capital plays the critical role of allocating its resources among those activities that are economically most productive. In doing so, it would also enable all stakeholders of the economy benefit from the returns in proportion to the capital deployed by them. However, it is the ability of these markets to provide free and fair access at an affordable cost through various instruments that could match the investor profiles and expectations would decide if these markets would be able to achieve their critical objective of making market-led growth an inclusive process. Capital, remaining at the helm of all economic activities including the basic exchange of all goods and services in an economy, would play a crucial role and hence economies at cross-roads of their evolution, such as that of India's, needs more efficient and well developed and widely participated capital markets that would enable the growth transition to be a smooth process. This article attempts to do health check per key market indicators to find where are the Indian markets and where are we supposed to be.

The Indian capital market had undergone significant evolution on the regulatory and structural paradigm since 1990s but has not been commensurate with the changes in the product 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. The very fact that India has only about 20 million direct users of capital market as opposed to China which has 200 million registered depository users that there is a lot that capital markets would have to penetrate to make the Indian growth story more inclusive. Broad based market development has always been the theme around the world as more investor means more wealth creation and distribution in society and also better allocation of risk capital.

Can Technology Herald a New Era?

With the use of technology, the Capital Markets globally have become more faster in terms of 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. Increased capital market activities would stimulate rapid growth and economic growth in turn would attract higher participation and innovation in capital markets. Evidently, this had been the force behind the developed economies. 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 of global capital market transformation, but has not been able to achieve the synchronized cycle of capital market and economic growth due to various other factors like, lack of innovation in products and connectivity with the retail, lower level of investment-based participation and increasing intraday trading psychology prevailing in the market due to the cash settled F&O market, enablement of institutional intermediation I.e. through banks, etc. Banks remain a significant distributor of capital market related services with the help of increased credibility as enjoyed by the Banks among its deposit holders. Indian economic growth story has much been trusted by the global participants and their participation has been increasing at a rapid rate than the growth in domestic investor participation (Table 1). As a result we continue to remain vulnerable not only in the market but when we consider economy as a whole leaving us affected significantly by an economic event that is remotely connected to the Indian business performance. Domestically, Indian economic growth is neither reflected in resource allocation through primary market nor supported by significant change in any other data on capital market, like, increased use of a financial instrument or through wider penetration of investing population.

Table 1: Net 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
2011-12	93,725
Figures are in Rs Crore (Source: SEBI)	

In a country with population of about 1.2 billion having a saving rate of more than 30 percent, merely 2 percent of them are participating in Indian Capital Market through demat account throws structural opportunities that the market can achieve through increasing intermediation and market literacy. A quick comparison of the market participants across major market across the globe, as shown in Table 2, indicates that the capital market participation in India represents about 20 percent of its Internet users and about 2.5 percent of mobile users, the major mediums of communication enabling markets to connect to the last mile. In the USA, the comparable numbers stand at 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.

Table 2: Need for Synchronized Growth in India					
Parameter	**US**	**UK**	**China**	**India**	**Singapore**
GDP (US$ Bn) (2010)	14,527	2250	5878	1631	314
Population (in Mn) (2011)	313	62	1,341	1220	5.1
Market Cap. (US$ Bn) (May 2012)	12,451 (NYSE)	3,105 (LSE)	2,559 (SSE)	1035 (BSE)	637 (SGX)
Gross household savings rate as percentage of disposable income (2008)	4.4%	2.5%	28%	34%	34%
No. of mobile phone connections (in Mn) (2011)	326	80	940	683	7.30
No. of Investors (in Mn) (2011)	110	10	200	21	2
Source: www.CIA.gov and others					

The challenges in the capital markets arena have underlined the need for heralding third generation financial sector reforms fuelled by technology that would not only enable access but also groom the retail investors from basics of capital market investments and through arming with necessary information as available with their institutional counterparts.

The Savings - Investment Disparity

With the current robust household savings rate of more than 30 percent, channelization of savings into investment in capital markets has not been direct with about 55 percent of savings being routed into physical assets, at a time even when a large number of corporates are in need of risk capital and the economy needs more businesses to make the growth process more inclusive through employment generation and to take care of structural shift. Additionally, the country observed mere 8% of resource mobilization through primary capital market during 2004-12, a period characterized by highly intensive in terms of capital churning needs of the

Table 3: 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	57,555
2010-11	67,609
2011-12	48,468
Rs Crore (Source: SEBI)	

business. This disparity needs to be rationalized without foregoing its impact on effective information convergence and its role in market efficiency.

Other major challenge lies in dispersing trade concentration and it can only be altered through spread of market participants across geographically as well as the economic strata. The participation in the real capital formation through risk capital shall be the obvious choice of the investors than just focusing on the fixed interest based investment. While, widening distribution network through channels of financial mobilization such as Banks, Post-Offices etc. would help the same. It would have to be complemented with increasing efforts on educating the retail participants with about various investments and trading motives along with associated Risk. It would encourage real capital formation helping the entrepreneur with domestic funds which would have prime domestic interest in perspective compared with the foreign capital that the market is currently dependent upon. If banks are allowed to distribute financial instruments at reasonable fees, it could channelize savings of financially literate investors and could widen the income base of these very banks from increasing dependence on rate differential and diversify into increasing fee based services. Another way to look at, they can provide all services under one roof essentially empowering retail participants as like their institutional counterparts.

Sustaining the Indian Growth Story

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 the existence of a broad-based market. This would facilitate easy criteria for financial agents to cross sell all financial products without handling money. Due to low per capita income and the larger size of the family dependent on it, traditional Indian middle class had been historically risk averse. Investors of this class largely depend on the insurance industry or the pension industry due to tax benefits and partly for securing future. However, these classes would now have the incentive of directly investing in markets through the introduction of Rajiv Gandhi equity based investment scheme. In addition to the Rajiv Gandhi Equity scheme, introduced in 2012 Budget, ESOPs to employees shall be made mandatory in the organized sector (including the public sector) which has about 29 million on its rolls. In fact, to start with, the government shall plan for structured sale of PSU shares for the retail investors including ESOPS to their employees, which makes them a partner in India's economic growth. These will form small steps towards fulfilling the objective of widening equity culture in the Indian economy and promotion of self sustaining economic activities.

Structural Change in Capital Holding: Need of the Hour

Indian entrepreneurship mostly being at an early stage of growth cycle, the promoter concentration in the equity holding has always remained 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 of shares 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 constraints in promoting equity culture while the economic growth could create increasing demand for stocks leading to a distorted demand – supply equilibrium in the Indian capital market. With increasing regulatory efforts this demand – supply equilibrium should be corrected before the inequilibrium distorts the return to risk capital.

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.

Need for Widening Domestic Institutional Base - Bridging Temporal Mismatch in Funds

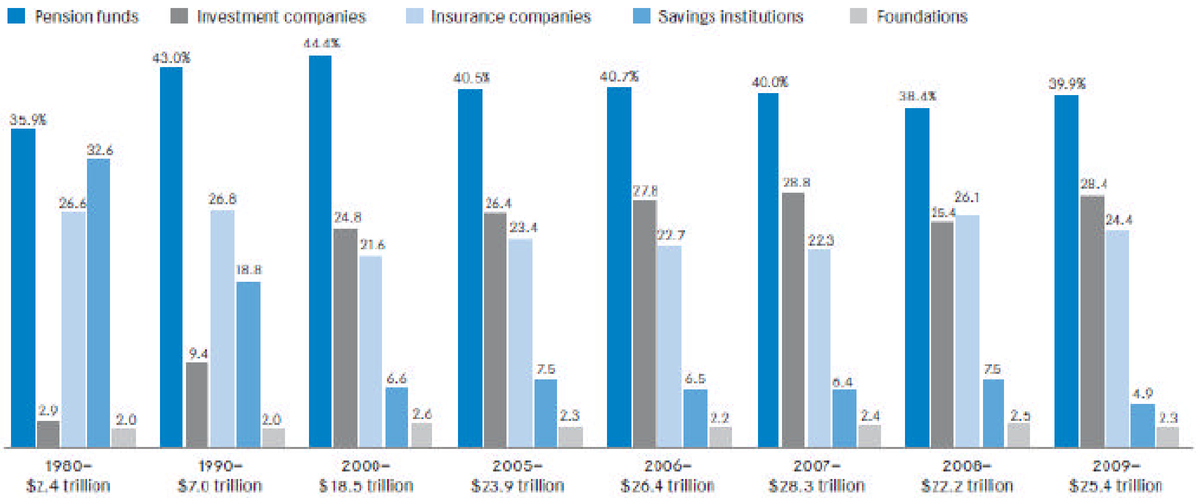
Increased participation from the pension funds in the respective capital markets not only helps in the capital market development but also has positive impacts on stock market depth and liquidity. In addition to the main purpose of coping with the economic pressures due to changing demography and fiscal situation, other motivations for pension systems as reflected above shall involve contribution to economic development by promoting national savings and capital market development. Additionally due to the longer-term nature of their liabilities, pension funds have incentives to invest more in illiquid and long-term assets that yield higher returns, and thus provide augmented supply of long-term funds to the capital markets. With the bias towards fixed-term instruments, asset allocation has been done mostly through investment in fixed-income instruments. The participation of corporate bonds in the portfolio of pension funds is also increasing. In fact if we look at the global pension fund portfolio allocation in 2010, it is quite evident that equity constitutes significant presence in the pension fund portfolios across countries (Table 4).

Table 4: Asset Allocation of Pension Funds (%) across Countries					
Country	**Equities**	**Debt**	**Real Estate**	**Mutual Funds**	**Others**
Finland	47.6	37.0	8.8	-	6.6
United States	38.1	20.6	1.2	22.5	17.4
Poland	36.3	59.4	-	0.6	3.8
Canada	26.9	25.8	5.5	33.6	8.3
Turkey	25.8	26.9	0.4	-	46.5
Australia	25.1	5.2	5.3	49.4	15.0
Mexico	16.8	79.9	0.0	2.4	0.9
Chile	15.9	35.9	-	42.7	5.5
Norway	15.7	49.7	3.4	26.7	4.5
Denmark	15.2	68.8	1.1	2.0	12.9
Portugal	14.2	43.0	9.6	22.8	10.5
Netherlands	12.7	23.6	1.3	51.2	11.2
Spain	11.2	53.3	0.2	7.4	27.8
Italy	10.3	42.4	4.5	9.8	33.1
Hungary	9.2	54.5	-	31.5	4.8
Belgium	8.8	11.0	0.7	72.1	7.4
Iceland	6.7	61.3	-	16.0	16.0
Israel	5.8	76.3	0.5	3.5	13.8
Source: OECD					

Importance of pension funds relative to the size of the economy in selected OECD countries, 2010

Pension fund size, in OECD countries', is 71.6% of GDP in 2010 which in case of India is less than 5%. Considering the demographic change and increase in retirement demand compared to increase in saving, India needs to increase the pension fund corpus. Institutional investors have become increasingly important for both asset management and the development of financial systems. In fact, institutional investors are likely among the most important conduits of private and public savings, supplying capital for firms and countries to grow. Among institutional investors, privately-managed, pension funds have played a crucial role across countries. In the US the pension fund constitutes nearly 40% of all institutional assets.

Share of total institutional assets (by type of institution), 1980-2009



Note: "Savings institutions" includes savings and loan associations, mutual savings banks, and federal savings banks. As of 2008, the Federal Reserve System discontinued reporting data on bank trusts and estates, which were previously computed under this category of institutional investors.

Source: The Conference Board, 2010.

Excess Return through Equity Allocation – Opportunity for Pension Funds in India

If pension funds were allowed to participate in the Capital Market in India then they would have generated a higher return than their managers had as obligation. A return analysis of various classes of equity exposure over the investment horizon of April 01, 2000 to March 31, 2011 indicates the return range of 13.5% to 22.3% (Table 5). In contrast, the current statutory rate of return is 8.25 percent.

Table 5: Return from Equity Linked Investment over a Horizon of 2000-2011

	BSE PSU	SENSEX	BSE 100
Return	693%	283%	242%
Annualized Return (CAGR)	20.7%	13.0%	11.8%
Average Dividend Yield	1.6%	1.6%	1.7%
Total Return	22.3%	14.6%	13.5%
Annualized Risk	35%	27%	30%

Source: MCX-SX Research

Manageability of Equity portfolio of Pension Funds

Indian Mutual fund industry is managing its AUM (Asset under management) of more than Rs 7 Lakh crore. If the pension fund is allowed to invest in Equity to the tune of 10% of its investment, the incremental corpus would be less than Rs 50,000 Crores. This incremental corpus appears, considering the size of mutual fund AUM, to be manageable with ease. Pension funds could start to allocate a portion of their fund, to be invested in equity, through the existing mutual fund managed by the PSUs entities so that they have greater comfort. By doing so, the risk of corporate governance will be minimized at two stages, one the entire equity portfolio of the pension fund will be managed by an AMC of the PSUs and the investment of entire corpus may be restricted to PSUs only. Such investment of 10% of the pension funds in Equity would generate an annualized excess return of more than 100 basis points for the entire corpus. Later, the equity allocation shall be increased and investment may be broadened to other non-PSU companies as well.

Pension funds alike other institutional investors provide means of risk pooling for smaller individual investors, thus providing diversification and enhanced risk-return opportunities. Their superior capacity to absorb and process information, and their ability to transact in large volumes, not only lowers the cost of intermediation but also benefits investors and businesses and financial institutions alike. In addition to providing better risk management and lower transaction costs, their long-term liability structure allows pension funds to invest in and contribute to the development of longer-term securities markets. They not only contribute to better transparency and governance but also to the overall improvement of market microstructure and market efficiency.

Research studies have also demonstrated that pension funds react asymmetrically to stock market shocks. Equity reallocation is higher after underperformance of equity investments than after outperformance. In particular, with excess equity returns only fewer portfolios were rebalanced, while during negative shocks there has been comparatively higher rebalancing indicating their non-bubble creating and bubble–burst impact absorbing nature of participation. The former can be indicated as a “buy on the dip” strategy and the latter as a “the trend is your friend” approach. Apparently, equity portfolio managers are able to convince pension funds both to replenish their funds in bear markets (to profit from low asset prices) and to increase the equity allocation in bull markets (to take advantage of rising markets).

Case for broadening the Rajiv Gandhi Equity Linked Saving Scheme - Individual Savings Account

An **Individual Savings Account** (**ISA**) is a financial product available to residents of the United Kingdom designed for the purpose of investment and savings with a favourable tax status based on *Tax-Exempt-Exempt* model. Cash and a broad range of investments can be held and there is no restriction on when or how much money can be withdrawn. Though this is not a pension product but can be a useful complement to a pension for retirement income. There are two broad types of ISA, cash or stocks and shares.

Cash ISA is a cash deposit that is similar to any other ordinary savings account, apart from the tax-free status. In **Stocks and shares ISA,** the money is invested in ‘qualifying investments’ - various direct and indirect capital market based financial instruments. As a consequence, the risk profile of the ISA may be anything from low to high depending on the mixture of investments used. In addition, UK also allows Junior ISA which allows parents to invest money in the name of children to be withdrawn at a later point of time.

While efforts for increasing the financial literacy is being undertaken, the next obvious step for policy makers would be to broad-base the Rajiv Gandhi Equity Linked Savings scheme on the similar lines of the ISA would not only help widening equity culture in the Indian economy but also promote self sustaining economic activities for long-term economic health of the nation.

Conclusion:

Various studies indicate that capital markets play the critical role of wealth creation and wealth distribution in the economy besides improving the employment with subsequent benefits on improving skill sets and employability of the working population. However in order to reap the full benefits of capital markets to the real economy, it is necessary to strengthen intermediation and wider participation. Enhancing the equity exposure of long term funds such as pension funds and making NPS Tier I mandatory for the organized sector would not only nullify the mismatch of long term capital need and supply, but also make the growth process more inclusive. Besides NPS Tier II account, which are in anyway voluntary in nature, holders shall be allowed to freely determine their portfolio. In order to encourage the equity holding among organized sector, ESOP should be made mandatory. Government may set the ball rolling by special sale of their equities to their employees. Broadening of Equity culture may also sub-serve the government vision of its social responsibility towards financially empowering the savers to maintain standards of life, post their productive phase (retirement). An Exempt-Exempt-Exempt model of saving scheme, in line with ISA of UK shall help in popularizing investment culture

among tax payers, which shall over a period of time be converted to Tax-Exempt-Exempt model. The above measures, if introduced in a phased and calibrated manner, would help in sustainable wealth creation and distribution. Existence of vibrant capital markets which are globally benchmarked can accelerate the process of transformation of the growth process into a socially and economically sustainable experience.