India's Capital Markets : Challenges & Opportunities

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Capital markets have truly become the barometer of a country's economic performance. In India, the financial sector in general and the capital markets in particular, have seen a comprehensive set of reforms in nineties, and consequently have acquired greater depth needed for sustained growth of Indian economy. I feel this is the most opportune time for examining and assessing the impact, challenges and opportunities arising from global and domestic developments as well as from changing market practices and regulations relating to Indian capital markets.

This paper focuses on the reform measures introduced in recent years for development of India's capital markets, examines the current state of the capital markets and deliberates briefly on some of challenges facing the capital markets in India.

Developments in the Capital Markets

Role of Capital Markets

In India, although the Stock Exchanges have been in existence for over 100 years, their role acquired significance in mobilisation of savings and channelisation into productive investment, only in the 70s and the 80s, though the market was subject to Government control and regulations. In nineties, the capital markets, however, have emerged as an important source of capital mobilisation and witnessed considerable growth, following comprehensive set of reforms introduced in this areas as a part of financial sector reforms.

The extent of growth in capital markets in India can be measured by the fact that as against an amount of about $ 6 billion equivalent mobilised during the 10 year period up to 1990-91, the amount mobilised during six years between 1991-92 to 1997-98 increased over eleven-fold to around $ 68 billion. In 1990 the pre-reform period, 75% of incremental financial savings went to banks and approx. 25% to the capital markets. In 1996 the banking sector received 47% of the household savings and the equity market 53%. Thus there has been a marked shift towards capital markets from the traditional banking system.

The secondary market too has grown significantly, and market capitalization on National Stock Exchange (NSE) has increased from $ 94 billion in November 1994 to $ 132 billion in April 1998. Net cumulative portfolio investments by FIIs have crossed $ 9 billion mark. The substantial flow of foreign portfolio investments has made the trade volume on stock exchanges increase considerably.

Capital Market in the Post-Liberalisation era

The capital markets have reached these levels thanks to a series of comprehensive reforms measures introduced by the Government since 1991-92. Among the various measures introduced the abolition of office of Controller of Capital Issues together with free pricing of issues by corporates constitute perhaps the most important developments in the capital market in the post-reform era. Another landmark was the establishment of Securities and Exchange Board of India (SEBI) with statutory functions and powers to bring about a healthy and orderly growth of the capital market. SEBI has truly transformed the capital markets through a series of well designed and well sequenced reforms measures introduced over the last few years covering both the primary and secondary markets.

Primary Market

The focus of policy measures in the primary market has been the protection of investors' interests through strengthening the standards of disclosure and issue procedures, introduction of prudential norms for issuers and intermediaries and removal of systemic deficiencies in the issue procedures.

To protect interests of investing community and also to provide greater flexibility to the issuers, the SEBI issued a new set of Guidelines on Capital Issues in 1992. Companies in India can now enter the market directly with a variety of instruments and determine issue prices in accordance with their market perceptions and in conformity with certain guidelines relating to disclosure and investor protection. Also, no longer offer documents need to be vetted by the SEBI; merchant bankers/issuers would remain responsible for ensuring compliance with the norms on disclosure and investment protection prescribed by SEBI.

In addition, several new market intermediaries including mutual funds and FIIs have been permitted to operate, making the capital markets much more diversified. Several reform measures have been introduced to attract investments from Foreign Institutional Investors (FIIs) both in the primary and secondary markets.

Secondary Market

The emphasis of secondary market reforms has been towards upgradation of post-trade infrastructure to international levels. Secondary market policy improvements assumed the form of greater transparency in trading system, reduced settlement cycles, extension of screen based trading and introduction of forward trading with adequate safeguards.

In India, as the reform process gains momentum, capital markets have to play an important role as provider of capital resources. The resource requirements to sustain a higher growth and especially the investment needs of the infrastructure sector are indeed very large. Much of the needed investment is expected to come from increased private sector participation in industrial development. In this context, an efficient capital market institution becomes a pre-requisite for providing a conducive framework for investors, issuers and various financial intermediaries.

With a sharp increase in the number of companies accessing capital markets and the burgeoning investor population in the initial phase of reforms considerable strain had been placed on systems and procedures in stock exchanges. Combined with the extremely cumbersome and time consuming procedures for taking and giving delivery of scrips, the existing mechanism was found to be quite inadequate to operate efficiently. Therefore, a need was felt for an alternative mechanism. Screen based trading systems and automated settlement systems were considered to be essential.

Thus, was born the National Stock Exchange of India (NSE) in 1994 which introduced for the first time in India nation-wide fully automated screen based trading facilities to investors in line with international markets. IDBI has promoted more than a dozen important institutions in the country. But we feel extremely proud for being the nodal agency for setting up NSE.

NSE has now carved a niche for itself with its commitment to efficient operations, discipline and transparency of systems and procedures and in less than 5 years has emerged as the country's largest exchange. NSE today serves investors from over 186 cities in India. Currently, 890 debt securities and over 1350 scrips in the equity segment are being traded on the screen driven exchange. Average daily traded value is of the order of about $ 100 million in debt securities and over $ 500 million in the equity segment. In volume terms, the average daily numbers of trades in equity segment have gone up from 900 trades in November 1994 to a record high of about 3,00,000 trades in April 1998 which makes NSE one of the seven largest stock exchanges in the world.

Another important development has been the setting up of National Securities Depository Ltd (NSDL), which has ushered in an era of dematerialised trading. NSDL set up jointly by IDBI, UTI and NSE is moving fast towards a cost effective national clearance and depository system. This will help in cutting transaction costs, significantly reducing delays in transfer of ownership of securities, creating liquidity for holdings and ensuring better investor protection.

The first one and a half years of NSDL saw several developments on the depository front. The depository infrastructure grew with more companies, depository participants (DPs) and stock exchanges joining NSDL. As on date, 203 companies, constituting 60 per cent of total market capitalisation, have entered into agreements with NSDL. Amongst these, dematerialised facilities is available for shares of 184 companies. At present, NSDL has 55 Depository Participants, who are catering to investors from 219 locations across the country. Further, the two largest stock exchanges viz. the National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE) have joined NSDL to facilitate settlement of trades executed in their dematerialised segments. It is very encouraging to note that many global custodians have recommended the use of NSDL to their clients in the US and other countries.

In addition, the affirmative regulatory intervention has imparted additional momentum to the depository process. For instance, SEBI has made it mandatory for FIIs, MFs, Banks and FIs to sell only in the dematerialised segment with respect to a select list of securities. Further, with effect from April 6, 1998, SEBI has allowed delivery of dematerialised shares in physical segments of NSE and BSE, thereby alleviating all concerns relating to the liquidity of dematerialised holdings.

Development of Debt Market

Primary Debt Market

Let us now look at the developments in debt markets in India. In the pre-reform period the Government securities market remained almost dormant with borrowing at pre announced rates, targeting a captive group of investors. This, coupled with automatic monetisation of budget deficit prevented a deep and vibrant Government securities market from emerging. Since 1992, Central Government borrowings have been undertaken at market related rates, primarily through auctions of Government securities of different maturities. RBI introduced innovative instruments like, conversion of Treasury Bills into term security and zero Coupon Bonds. RBI has also announced a Capital Indexed Bond as a hedge against inflation. A 14 day Intermediate Treasury Bills was introduced to enable State Governments, foreign central banks and other specified bodies to invest their temporary surplus funds.

The other segments of the primary debt market is PSU debt market and corporate debt comprising industry, financial institutions, banks and finance companies. In the post-reform era, the primary debt market is dominated by FIs & PSUs. The corporate sector has accessed it only to a limited extent. This segment has considerable prospects for growth.

Secondary Debt Market

In order to deepen the secondary debt market in Government securities, the system of primary dealers (PDs) was introduced, and later, with a view to broadening the market with a second tier of dealer system, guidelines for Satellite Dealers (SDs) were issued. To further deepen the Government Securities market, a scheme of liquidity support to mutual funds dedicated exclusively to investments in Government securities was evolved. This has led to substantial growth in secondary market trading in Government securities. However, secondary market for non-Government segments have yet to develop.

CHALLENGES FACING THE CAPITAL MARKET

Subdued Primary and Secondary Equity Market

Now, I would like to deal with some of the challenges facing the capital markets in India which need to be adequately addressed to realise the vision of an efficient market system.

In the primary equity market, a major challenge currently is the revival of the depressed conditions of the market. The sluggishness of the primary equity market which is continuing for over two years is attributed to various factors including investors apathy which is mainly due to poor performance of a large number of scrips floated with a high premia during 1993-95 following freeing of the pricing. The matter was compounded by irregularities noticed in the pricing of some of the issues which imparted considerable negative influence in the minds of investors. Further, there was a liquidity constraint in the financial system during 1995-96 and large part of 1996-97 which led to spurt in interest rates diverting investors' preference from equity to debt issues in the primary market.

The continued subdued nature of the primary equity market has become an area of major concern today as it is hampering implementation of many industrial projects causing time and cost overruns and thereby affecting the industrial growth of the country.

In the primary equity market a happy development has been the successful issues of several banking industry shares which have received good investor response despite most of the issues being premium issues. This underscores the need for the introducing quality issues by the corporate sector. FIs like ours are ready to provide underwriting support. What is lacking is the confidence on the part of good corporate entitites to test the markets. I am sure, investors response will be good in case appropriately priced quality corporate issues are launched.

The secondary equity market has also remained subdued over the past two years, although it has shown some revival trends, confined to a few select scrips. In a way revival of primary equity market depends crucially on the health of the secondary market. Policy reforms in the secondary market have been quite comprehensive so far as creation of efficient and transparent infrastructure is concerned. As stated earlier, India today has NSE which provides screen based automated and transparent trading. It has set up a clearing corporation to guarantee trades done on NSE.

Post trading facilities have improved considerably with the setting up of National Securities Depository Ltd. Other exchanges have also now computerised their operations, settlement cycles are being rigidly followed. There is also a gradual shift towards demat form of trading. However, Secondary markets have come to be dominated by the FIIs. The recent events in South-East Asia has to some extent affected their sentiments. Though it could be said that barring for a few months, there was always net inflow of FII's investment. What is required is to make the Indian FIs participate to a much larger extent than they are doing today. UTI and other mutual funds as well as LIC have to be much more active on the secondary markets.

Need for Secondary Market in Debt Instruments

Another major challenge facing Indian capital market is creation of secondary market in debt instruments particularly in corporate debt. The growth of long term corporate debt market is an essential requirement as private corporate sector in India has been assigned a prime role in development of infrastructure and other projects.

In India, corporate sector accesses debt mainly by way of term loans from financial institutions. However, with the reforms in capital market, role of securitised assets is likely to acquire considerable importance in future. There is a large agenda for development of corporate debt market in India comparable to international standards.

There are several issues which merit attention for development of a vibrant debt market. I strongly feel that to activate the long term corporate debt market in India, there is a need for further liberalisation in use of contractual savings like pension, provident fund and insurance, which provide large source of long term funds in the economy. Also, there is an urgent need for market making in corporate debt on the lines of Government securities. A distributive network of brokers and sub-brokers does not exist for debt instruments as it does in the equity segment. As a result, although a part of household savings is channelised into long term debt, it is largely in non-marketable forms. Debt securitisation has also to develop for which changes in the Stamp Act and Contracts Act need to be made.

Derivative Products

Another important challenge before Indian capital market is the development of market for derivative products. Developed capital markets have all introduced derivative products in financial markets. In India, this is a new and evolving concept. NSE has taken the lead in spearheading the demand for introduction of futures and options markets.

SEBI had set up an Expert Committee on Derivatives under the Chairmanship of Prof.L.C.Gupta which has recommended the introduction of derivatives trading in India. This has been accepted by the SEBI Board a couple of weeks back. The matter is awaiting Government of India's approval for amendment of the Securities Contract Act. NSE has already made the preparatory arrangements for commencing the trading as soon as the approval comes. There is thus every likelihood of derivatives trading starting sooner than later. The introduction of financial derivatives in the form of traded futures, including equity futures, currency futures and interest rate futures, would be a giant step towards the further development of the Indian financial markets.

INTERNATIONAL DEVELOPMENTS

Prior to globalisation of Indian economy, the stock markets were somewhat insulated from international influence. This is not the case any more. The recent S.E. Asian crisis has shown that due to high degree of integration or linkage among financial markets, the crisis can be quickly transmitted to other financial markets. India came out rather unscathed and did not experience the trauma faced by other countries. Partly it was due to the fact that full CAC has not been adopted and partly Indian Regulatory mechanism turned out to be far more effective than in other countries. In an integrated global economy, I feel it is imperative to take steps to regulate the markets effectively so as to retain investor confidence in a country's economy and particularly the stock market.

CONCLUDING OBSERVATIONS

In conclusion, I would like to reiterate that the capital markets here have come to play a crucial role in the financial intermediation process and have rightly been regarded as an important barometer of the impact of the reform process. Any discussion on the process of integration of the Indian economy with the world economy must perforce assess the role and ability of the capital markets in encouraging this process.

As I mentioned earlier, the reforms in the economic system has imparted a new dimension to capital markets in India. While liberalisation in capital market has resulted in many improvements in functioning of the stock markets, there are several aspects which still merit attention so that capital market can play a meaningful role in industrial & economic development. The sluggish trends in primary equity market needs to be reversed by restoring investors' confidence in the market. Secondary market trading needs to be broad based and various intermediaries, both in primary and secondary market should be strengthened to conform to international standards. Development of long term debt market, particularly, corporate debt market is an essential pre-requisite particularly for financing of infrastructure and other industrial projects. Regulatory and other aspects need to be looked into. Also, Indian capital market should mature to introduce derivative products for risk management in capital market.

The recent South East Asian crisis needs to be carefully studied. A market oriented system with appropriate regulation leads to growth with stability, otherwise there may be shocks both external and internal which might destabilise the economy.

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