DEVELOPMENTS OF CAPTAL MARKET IN INDIA AT LONDON SCHOOL OF ECONOMICS ON 2ND OCTOBER, 2006

by

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The Significance & History of Capital Market

The capital market is a place where the suppliers and users of capital meet to share one another's views, and where a balance is sought to be achieved among diverse market participants. The securities decouple individual acts of saving and investment over time, space and entities and thus allow savings to occur without concomitant investment. Moreover, yield- bearing securities makes present consumption more expensive relative to future consumption, inducing people to save. The composition of savings changes with less of it being held in the form of idle money or unproductive assets, primarily because more divisible and liquid assets are available.

The capital market acts as a brake on channeling savings to low- yielding enterprises and impels enterprises to focus on performance. It continuously monitors performance through movements of share prices in the market and the threats of takeover. This improves efficiency of resource utilsation and thereby significantly increases returns on investment. As a result, savers and investors are not constrained by their individual abilities, but facilated by the economy's capability to invest and save, which inevitably enhances savings and investment in the economy. Thus, the capital market converts a given stock of investible resources into a larger flow of goods and services and augments economic growth. In fact, the literature is full of theoretical and empirical studies that have established causal robust (statistically significant) two-way relation between the developments in the securities market and economic growth.

The Indian capital markets dates back to the 18th century when the securities of the East India Company were traded in Mumbai and Kolkata. However, the orderly growth of the capital market began with the setting up of The Stock Exchange, Bombay in July 1875 and Ahmedabad Stock Exchange in 1894. Eventually, 22 other Exchanges in various cities sprang up.

Given the significance of capital market and the need for the economy to grow at the projected over 8 per cent per annum, the managers of the Indian economy have been assiduously promoting the capital market as an engine of growth to provide an alternative yet efficient means of resource mobilization and allocation. Further, the global financial environment is undergoing unremitting transformation. Geographical boundaries have disappeared. The days of insulated and isolated financial markets are history. The success of any capital market largely depends on its ability to align itself with the global order.

To realize national aspirations and keep pace with the changing times, the capital markets in India have gone through various stages of liberalization, bringing about fundamental and structural changes in the market design and operation, resulting in broader investment choices, drastic reduction in transaction costs, and efficiency, transparency and safety as also increased integration with the global markets. The opening

up of the economy for investment and trade, the dismantling of administered interest and exchange rates regimes and setting up of sound regulatory institutions have enabled this.

Regulatory Efficacy

The capital markets in India were underdeveloped, opaque, dominated by a handful of players, and concentrated in a few cities. Manipulation and unfair practices were perceived to be widespread and rampant, prompting an overseas researcher to describe it as a “snake pit”. The transformation of the Indian securities markets was initiated with the establishment of the Securities and Exchange Board of India (SEBI) in 1989, initially as a informal body and in 1992 as a statutory autonomous regulator with the twin objectives of protecting the interests of the investors and developing and regulating the securities markets over a period of time. SEBI has been empowered to investigate, examine, visit company premises, summon records and persons and enquire and impose penalties commensurate with misconduct. The first and foremost challenge for the fledgling regulator was to create a regulatory and supervisory framework for the market, a job that proved formidable, because vested interests resisted every new step.

However, with the designing and notification of 32 regulations/guidelines (amended many times over), during a decade and half of its existence, the apparatus steadily evolved and has come to grips with the situation.

SEBI has instituted a consultative process of framing regulations. All reports / concept papers / policy proposals are posted on SEBI web site www.sebi.gov.in for comments from market participants and the public. The comments are compiled and considered before finalizing regulations. Even the draft regulations are put on the website before notification for legal pundits to comment if the law framed is in consonance with the spirit of initiatives. This has a profound impact not only in terms of receiving valuable input and building public opinion before framing regulations / guidelines but also in improving the quality, acceptability and implementibility. SEBI has formed a number of committees comprising of eminent experts and market practitioners to support it in the design of reforms for different aspects of the markets. The regulator posts all its orders, including those delivered on appeals against its orders, on its website. On request, it provides informal guidance on payments of nominal fees and issues no action letter so that the participants can seek clarity on any aspect and adopt appropriate business strategy in consonance with the applicable regulations.

SEBI has put time lines for performance of its various functions like registration and renewal on the web-site. These measures work as a self- disciplining mechanism within SEBI and provide full transparency to its functioning.

Primary Market

The primary market, which at one time was flooded with a number of issues floated by dubious promoters, depriving gullible investors of their life-time savings has since been transformed. The changes in this area have been epoch-making and include detailing of complete profile of promoters, comprehensive disclosures, the existence of tangible assets and a track record of profit as also reporting end uses of funds to the Company Board as a part of corporate governance, etc. Sometime back when the story of Google's IPO was being flaunted around the world in various sections of media as one of the greatest innovations of recent times in raising risk capital, the Financial Times, London, carried the following observation:

"The World's Biggest Democracy can show Google how to conduct an online IPO.

…in India you cannot apply on the web but investors can access one of the world's largest financial networks with 7000 terminals scattered around 350 cities. And every step of the book building process is public. . ...[T]he Indian system is a refreshing example of a transparent IPO market but it is also a rare one, especially in the insider-friendly Asian markets."

All the IPOs since the reforms started have been a success and barring a few exceptions are trading at a premium over the issue price. The regulatory framework has been modified to provide options to Indian firms for raising resources either domestically, or globally, or through both. This helps in price discovery and reducing the cost of funds. A number of Indian firms have raised money through American Depository Receipts (ADR), Global Depository Receipts (GDR) and External Commercial Borrowings (ECB). Two-way fungibility has been permitted to enhance liquidity.

During 2005-06, a sum of Rs. 273 billion, as against Rs. 232.71 billion in 2003-04,

And the amount raised was next only Hong Kong and way ahead of Japan, Korea & Singapore through primary market. In fact, the corporate sector and governments (Centre and States) together raised a total of Rs. 3.75 trillion from the securities market during 2005. Thankfully, so far, no major mishap has been noticed in the recent times.

Secondary Market

If a Rip Van Winkle woke up from a prolonged deep slumber of a couple of years, he would be amazed to see the quality of the secondary market of India. The deafening noise of an out-cry trading system has been replaced with a silence of a summer through the Electronic Consolidated Anonymous Limit Order Book, with price time priority matching being accessed through more than 10,000 terminals spread in over 400 cities and towns across the Indian sub-continent, something perhaps without a parallel in the world. The cost of transacting is the lowest, as compared to the most developed markets.

The Indian Settlement system conforms to the CPSS-IOSCO (Committee on Payment and Settlement-International Organization of Securities Commissions) principles and G30 committee (January 2003, under the chairmanship of Sir Andrew Large) recommendations, which even the most developed markets of the

world have been proposing to implement by end of 2006. The institution of central counter party (CCP), which provides full novation and guarantees settlement, has eliminated counter party risk entirely. Over 99 percent of the dematerialization of market capitalization and Straight-Through Processing (STP), mandatory for all institutional trades, have enabled Indian settlement system to function seamlessly, not withstanding the size and spread.

On a T+2 cycles, all scrips are electronically cleared fully through a central counter party (CCP) on a rolling settlement. The CCP of the exchanges, which operates a tight risk management system and maintains short (T+2) and consistent settlement cycle, is now financially potent to meet the obligations for 4-5 consecutive settlements even if all the trading members default in their obligations. The dynamic risk management system comprises capital adequacy norms, trading and exposure limits, index-based market-wide circuit breakers, margin (mark to market) requirements. The encashability of the underlying of the margins, comprising cash, bank guarantees and securities is evaluated periodically. The real time monitoring of broker positions and margins and automatic disablement of terminals with Value-added Risk (VaR) margining, built on much higher sigma deviation than the best of the markets in the world, has reduced the operational risk to the lowest ebb. In an unfortunate very sharp (over 25 percent in two days) fall of the market in May 2004 the strength of the risk management of the system got tested to the hilt. There was not a single broker failure or default and on the third day (after the two consecutive days of fall) the market functioned as if nothing unusual had happened. Even the CCP was not required to fund any broker- dealer's obligations.

The three- legged corporate compliance stool----- disclosure, accounting standards and board room practices -- has lifted India to the global pedestal in corporate governance. In a study titled "What works in Securities Laws? '' Professors Rafael La Porta, Florencio Lopez - de- Silanes and Andrei Shleifer have commented: "India scores 100% as far as disclosure standards are concerned". The Indian accounting standards are aligned with international accounting standards and are 'principle based'. One of the most sophisticated Pension Fund Managers, CalPERS gave a score of 3 (maximum that could be awarded) via permissible equity market analysis while voting for India as an investment destination. CLSA-CG Watch, in its September 2004 report, says: "In terms of consolidation, segmental reporting, deferred tax accounting and related party transactions, the gap between Indian and US GAAP is minimal."

On corporate governance it might be worthwhile to recall what the Economic Intelligence Unit 2003 study said: The Asian Experience incorporates - "Top of the Country class, as might be expected is Singapore followed by Hong Kong and somewhat surprisingly, India where overall disclosure standards have improved dramatically, accounting differences between local and US standards have been minimized and the number of companies with a majority of independent directors has risen significantly." CLSA-Emerging Markets Study on Corporate Governance gives India a score of 6.2, which is next only to 7.5 for

Singapore and 6.7 for Hong Kong.. None of the Indian companies listed on the NYSE or NASDAQ to the public knowledge has sought the benefit of transition time for the implementation of SOX requirements. What could possibly be more comforting is the CLSA – Emerging Market Study comment: “The Securities and Exchange Board of India (SEBI) continues to raise the bar for good corporate governance.”

It is not very appropriate to compare the Indian securities market with those of Singapore and Hong Kong. Singapore and Hong Kong are city states and have much smaller spectrum to watch: listed companies, broker-dealers, investors and even number of transactions. The Indian securities market is next only to US market in terms of size. Even though by all criteria of economic research, the size of market is determined by the market capitalization and trades in dollar terms, in actual operations, the market participants and the regulators have to grapple with the number of listed securities, market participants and the volume of transactions and that is where India stands out. The NSE is third largest exchange in the world next only to NYSE, NASDAQ, by the number of transactions, followed by the BSE, the fifth largest in the world. India has the largest electronic order book; NYSE and NASDAQ books are quote-driven. In the matter of single-stock futures, India leads the world, followed by EURONEXT which is just about half of its size. Even in Index-futures, NSE volumes are next only to the Chicago Mercantile Exchange and Eurex. No other market in the world, including that of Japan, compares with the volume of transactions of Indian markets. The ratio of the ((Turnover/ Market capitalization) *100) was 101% and compares very well with Japan & Taiwan were ratio is 137.20% and 147.30% respectively. The impact cost went below down to 0.08% in 2005-06 reflecting substantial improvement in liquidity.

The focus of development and the quality of regulation have not just centered on primary and secondary markets, they have also been directed at quality of intermediation and enforcement. The Mutual Fund industry of India which has gone through a host of reforms via the regulatory interventions today has some outstanding features like benchmarking Mutual Fund schemes, valuation norms, uniform cut-off time, comprehensive risk management etc. An independent study organized by the Asian Development Bank – Cadgon report testifies to this.

The investors and issuers can take comfort and undertake transactions with confidence if the intermediaries as well as their employees (i.) follow a code of conduct and deal with probity and (ii) are capable of providing professional services. All the intermediaries in the securities market are now registered and regulated by SEBI. A code of conduct has been prescribed for each intermediary as well as for their employees, in addition to applicability of fit and proper person regulatory standards. Further, capital adequacy and other norms have been specified and a system of monitoring and inspecting their operations has been instituted to enforce compliance. Disciplinary action is taken against them for violating any ground rules. All the intermediaries in the market are mandated to have a compliance officer, who reports directly and independently to SEBI non-compliance observed by him.

The Economic Survey 2003-04 by the Government of India had the following to say: "The securities markets have made enormous progress in recent years. India's equity market is now being increasingly recognized as a success story on the world scale." These reforms have boosted the confidence of investors (domestic and international) in Indian securities market. There are four parameters to ascertain the level of investor confidence: – (a) investments by FIIs, (b) growth of mutual funds industry, (c) subscriptions to the IPOs and (d) the increase in the number of accounts with the depositories. Let me quote the last financial year (2005-06) figures. The mutual funds mobilized net resources of about Rs. 520 Billion, equivalent to about one fourth of incremental bank deposits. Mutual funds' assets increased from Rs. 1.1 Billion at the end of March 2003 to Rs.300 Billion at the end of August 2006. Indian companies raised about Rs. 38 Billion through euro issues. The year gone by witnessed a net FII (portfolio moneys) inflow of US $ 14 billion.

The benchmark indices, namely the SENSEX and S&P CNX NIFTY, generated astounding returns of 83 per cent and 81per cent respectively, during 2002-03 and 2003-04. The market capitalization grew from Rs. 7 trillion at the end of March 2003 to Rs. 14 trillion at the end of March 2004 to Rs 28 trillion as on June 2006, indicating that the equity market is bigger than the banking system. The primary issues in the last year added at least Rs. 2 trillion market capitalizations. The trading in cash segment of exchanges increased from Rs. 9,32,062 crore in 2002-03 to Rs. 23,85,632 crore in 2005-06**.** The trading in derivatives increased from Rs. 4, 42,332 crore to Rs. 48, 40,362 crore during the same period. The turnover in government securities increased from Rs. 1,941,621 crore to Rs. 2,639,897 crore. The number of demat accounts with the Depository Participants (DPs) has increased considerably during the last three years from 3.5 million to 8.5 million & is increasing at the rate of over 100,000 per month**.**

The efficacy of the market where entry and exit are possible at will and the liquidity has spread from being skewed to just about 100 to more than 500 securities, is a matter of substantial comfort. Over 2,500 securities (equity) are traded for more than 100 days in a year. The overseas investors are no more glued to researches and assessments on index stocks and have been observing keenly and investing in the mid-cap segment.

The changes in the market have been really fast-paced and it has been possible with the co-operation of all the market participants, other regulators and the Government of India.

Road Ahead

However, I would not like to hand out the impression that in the Indian capital markets everything is hunky dory and needs no improvement, polishing or refurbishing. In fact, dynamics of the global environment dictate that those charged with the responsibility of bringing about changes must always seek out new

learnings by experience, criticism and judgments. The market depth needs to be supplemented with further product diversification-mortgage and asset backed securities, warrants, and disinvestment in the public sector. The debt market of India, though large and next only to Japan, in Asia lacks vibrancy and does not provide adequate options for meeting medium to long term funds, required for green field projects, in particular. Infrastructure funding (essential for continued high economic growth) has become an issue in the absence of a vibrant debt market. There is no market for below investment - grade paper or what is called junk bonds.

The agenda, includes making the corporate debt market vibrant : cash and future, operationalization of Indian Deposit Receipts (IDRs), and corporatisation and demutualization of remaining stock exchanges (has already begun with Stock Exchange Mumbai) where the ownership, management and trading rights resides with three different sets of people in order to avoid conflict of interest. The settlement cycle has to migrate to T+1. New products are to be introduced to meet the needs of all kinds of market participants. MAPIN (unique identification) has to be extended to cover entirety of market participants. National training and skill delivery institute has to be commissioned quickly to build a cadre of professionals to man the specialized functions in the capital market. There is a need to spread equity cult and build institutions like pension funds to enlarge the size of the market and balance volatility.

The regulation of listed companies, a job performed in a fragmented manner by SEBI and Ministry of Company Affairs, needs to be consolidated to eliminate regulatory arbitrage, shooting out from the kinks of regulatory jointing by unscrupulous operators, and blurring of regulatory accountability

Further, regulation is an evolutionary process and has to be refined on an ongoing basis. Thus, SEBI would and should continue to travel on the learning curve with a view to reorient and reconfigure ground rules (regulations), its investigating abilities and investor protection measures.

India will do well because it is fully convinced that capital markets allow people to do more with their savings and ideas and talents than would otherwise be possible. In the process, it would also facilitate increasingly larger number of citizens participating in the capital market in some form or other and share the opportunity of profiting from economic gains. Let me conclude with a recent opinion expressed by Mr. Steeve Vickers, President International Risk 'FINANCE ASIA published in Finance Asia.com on Sept , 29th 2005, " The stock market has been transformed from proverbial den of thieves to one of the most transparent automated and well regulated in the world – with record foreign institutional investment inflows a testimony to this."