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Opportunities & Challenges

Indian Financial Markets – Roadmap 2020

Mapping the Way Forward

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Prologue

ASSOCHAM has emerged as the fountainhead of Knowledge for the Indian industry, which is all set to redefine the dynamics of growth and development in the technology driven cyber age of 'Knowledge Based Economy'. To empower the Indian enterprise by inculcating knowledge that will be the catalyst of growth in the barrier less technology, ASSOCHAM has always been in the forefront to bring current issues for the industry and business for fruitful deliberations.

The journey of Indian financial markets has been of many shades over the last decade. We have seen a lot of progress, but also significant pauses. Many twists and as many turns. Awe inspiring growth punctuated by its gasping lack of inclusiveness. Presumably, these are the teenage pangs of a free economy which is jostling for its rightful place in the Globe. The fastest free market economy is now face to face with the challenges and opportunities to opt for either slow and steady or fast and furious growth, in the next decade.

In view of these imperative issues and developments in the financial sector in India, which has remained relatively immune to the global financial turbulence through a proactive response to the challenges, ASSOCHAM has come out with a study paper jointly with PwC on "Indian Financial Markets - Roadmap 2020" to assess the journey and mark destination for the 2020 target. This has been a great effort and will be a handy guide to policy makers, business houses, management fraternity and related stakeholders to find and ascertain challenges that may be faced by the Indian Economy.

I not only wish the conference a great success but also assume that ASSOCHAM shall continue to organize such programs for larger public benefits with great degree of excellence. ASSOCHAM extends earnest thanks to PwC as our knowledge partner in this conference and also thanks to industry partners, and all stakeholders without their assistance, this event could not have seen the light of the day.

With Best Wishes,

D S Rawat
Secretary General
ASSOCHAM

Foreword

The financial markets in emerging economies like India have exhibited a strong growth momentum, driven by a robust economic demand, consumption and savings rate. Although growth of the Indian economy suffered some disruption due to the economic downturn, the financial system proved its resilience with time. The Indian markets have shown quick signs of recovery, positively impacting the general global economic front.

There needs to be a well-defined framework which will withstand disruptions and lead the financial markets towards growth and progression.

Asian Development Bank, in its 2010 Asian Development Outlook, mentions that Developing Asia, a diverse group of 45 economies including China, India, Tajikistan, Samoa, and Indonesia, will grow 8.2% in 2010 and 7.3% in 2011. Similar to other emerging economies, India has also proved an attractive destination for investors, having exhibited a moderate growth even during the global downturn. The Financial Development Report (FDR) published by the World Economic Forum, ranks India 38 out of 55 countries, considering 120 variables like financial stability, size and depth of capital markets and business environment among others.

The equity markets in India can be appraised with those of the developing nations, in terms of market capitalization, regulatory framework, turnover and risk management. In 2010, FIIs have invested a significant $19.9 billion in Indian equity, while overseas funds have bought $9.9 billion worth of Indian bonds. However, as emerging nations face a persistent challenge of volatile capital flows with massive global de-leveraging, reversal of capital flows lingers as a potential threat for the Indian financial markets.

The banking sector continues to be one of the prime drivers of economic growth. Strong fundamentals in the banking sector, supported by increased credit and growth of assets have resulted in increased profitability. Banks today, have increasingly realised the need to outgrow plain vanilla offerings, and deliver products which are cost-effective, flexible and tailored to the needs of the rural customer. Moreover, a focus on inclusive growth has taken centre-stage involving huge investments in technology.

Infrastructure financing has been identified as a growth engine of the financial markets. The rapid pace of economic growth has led to an even higher unfulfilled demand for infrastructure development. Long term funding for building infrastructure is a big challenge considering the dormant corporate bond market and poorly developed debt market which needs to be scaled up to a great extent to match its steps to the economic growth momentum.

Development of financial markets cannot be complete without a robust regulatory environment attempting to keep pace with innovation in the market. Regulatory measures mandated by the central authorities act as a safeguard for financial institutions, shielding them from vulnerability. Increased volatility and constant upheavals in financial markets has made it necessary to pre-empt systemic risks in order to effectively manage them effectively. Good governance and a well designed macro prudential framework are essential components to ensure financial stability, going forward.

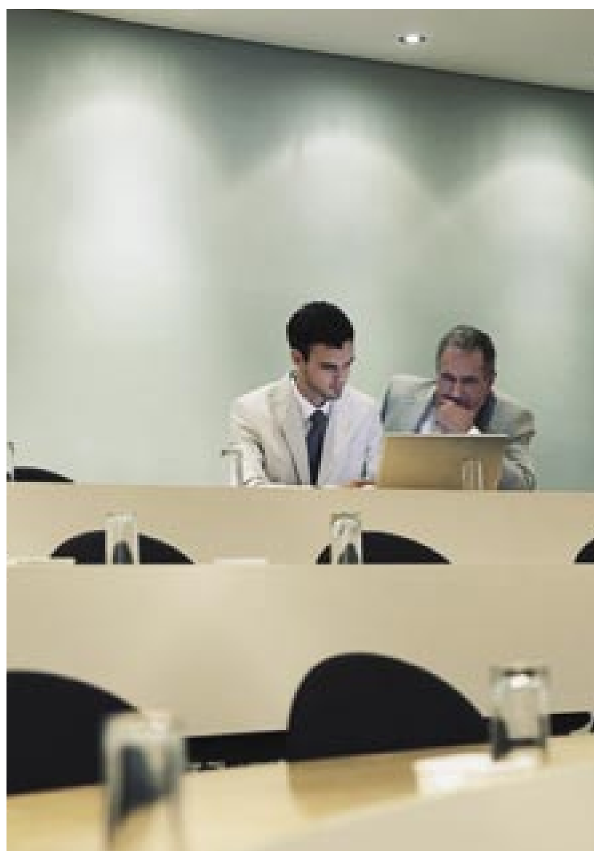
A huge challenge for financial institutions today is functioning and retaining their efficiency in such uncertain times. Business models are undergoing a structural change to accommodate the changing regulations and foster growth.

In conclusion, we can say that there needs to be a well-defined framework which will withstand disruptions and lead the financial markets towards growth and progression. Core elements like efficiency, stability, transparency, inclusion and sustainability will play a vital role in determining the growth trajectory of India. Standardising and harmonising the regulatory norms will help India position itself prominently on the global pedestal.

Jairaj Purandare
Executive Director & Leader
– Financial Services
PwC India

The Indian Banking Sector

India spearheads growth amidst other emerging nations



India is one of the five countries classified as big emerging market economies apart from China, Indonesia, Brazil and Russia. A study by World Bank predicts that by 2020 the share of these five biggest emerging markets' in the world output will double to 16.1% from 7.8% in 1992. This surge in growth is supported by an expanding middle-class population, with an increase in public and private investment. India has a strong middle class of 250-300 million expected to double in the next two decades. The country is set to become the fifth largest consumer economy with aggregate consumption likely to grow to 1.53 trillion USD in 2025.

Banking systems around the world face diverse challenges by nature of their businesses. In India, the banking sector has largely influenced the growth of the financial markets.

Banking systems around the world face diverse challenges by nature of their businesses. While developed economies like the United States, struggle with real estate markets, banks in some parts of Europe are left to deal with high funding costs arising due to sovereign risks. Some of the Japanese banks have low capital, weak profitability, and a high exposure to Japanese government bond markets. In emerging economies, the banking sector in the recent past has been shaped by a good deal of activity in terms of privatization, consolidation and entry of foreign banks.

In India, the banking sector has largely influenced the growth of the financial markets. The global banking landscape is changing rapidly, and our domestic banking system needs to gear up in order to keep pace with its global counterparts. To sustain itself amidst fierce competition, the Indian banking industry needs to undergo transformation from a strategic viewpoint, focusing on aspects of scale, scope, prudence and knowledge. These focus areas in turn, should be targeted to bolster productivity, efficiency and profitability, with the aid of customized technology.

Statistics indicate that in emerging markets, banking reaches only about 37%of the population, compared to over 50% penetration for mobile phones. For every 10,000 people, these countries have one bank branch and one ATM, but 5,100 mobile phones. In India, there exists a large un-banked population with only around 40% having access to banking services. This clearly reflects that increasing penetration in un-banked areas is a key challenge for the banking industry and currently, all efforts are being concentrated in this direction.

Financial Inclusion comes under the spotlight

Financial inclusion can be interpreted as a process which ensures ease of access, availability and usage of financial services by the under-privileged and excluded section of society at an affordable cost. The term financial inclusion does not indicate merely micro finance, but encompasses usage of savings, loans, remittances and insurance services, at an economical cost. The drive for financial inclusion needs to be tempered with an equal measure of financial literacy which includes awareness and knowledge of the target group (low income group) to make decision on savings, borrowings and some planning for future income.

Another set of statistics indicate, that only 37% of bank branches of Scheduled Commercial Banks are present in rural areas, with only around 40% of the population holding bank accounts. Moreover, out of the 600,000 habitations in the country, only about 30,000 have a commercial bank branch.

Limited Rural Population

Debit card holders constitute only

13%

and only 2% have a credit card

Of nearly 89.3 million farm households

51.4%

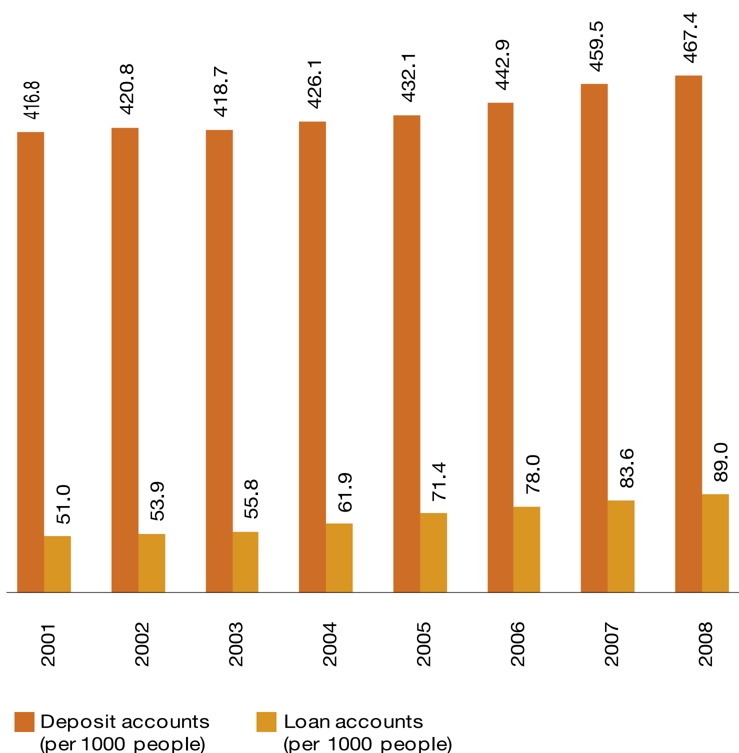
do not have access to any credit either from institutional or non-institutional sources.

Among farm households

13%

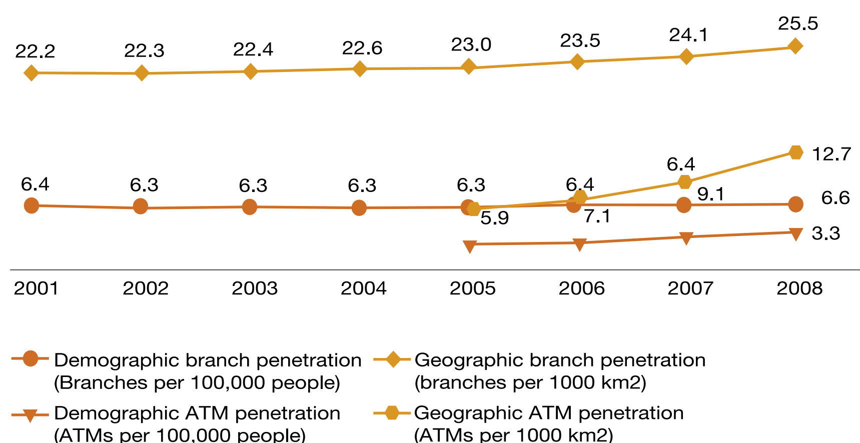
are availing loans from the banks are in the income bracket of < Rs. 50,000.

Figure 1: Penetration of Banking Services (Loan and Deposit accounts)



Source: RBI

Figure 2: Penetration of Banking Services (Branch & ATM penetration)



Source: RBI

The indicators given in Figure 1 & Figure 2 reflect the low penetration level of banking in the country.

These statistics emphasise the need for people to get connected with the banking system, availing a range of transactions, payment services, access to affordable credit, insurance and savings products.

Financial Inclusion being a policy priority, it is appropriate at this time to discuss some of the broad initiatives undertaken by RBI.

RBI initiatives for inclusive growth

- Nationalization of banks
- Identification of priority sectors, establishing RRBs, LABs, with a credit delivery focus in rural areas through the Service Area Credit Plans
- Simplification of the KYC norms, introduction of no-frills accounts, Kisan Credit Cards, General Purpose Credit Cards, small overdrafts in no-frills accounts and permitting banks to use the business correspondent and the business facilitator models
- Increased emphasis on mobile technology based banking

The RBI 100 % Financial Inclusion Drive

- In order to have focused attention for the financial inclusion efforts, the State Level Bankers Committee (SLBC) has been advised to identify one or more districts, one district in each state, for 100 % financial inclusion. Responsibility is given to the banks in the area for ensuring

that all those who desire to have a bank account are provided with one, by allocating the villages among the different banks.

- The 100 % financial inclusion drive is progressing all over the country. So far, 431 districts have been identified by SLBCs for 100% financial inclusion. As on March 31, 2009, 204 districts in 18 States and 5 Union Territories have reported having achieved the target.

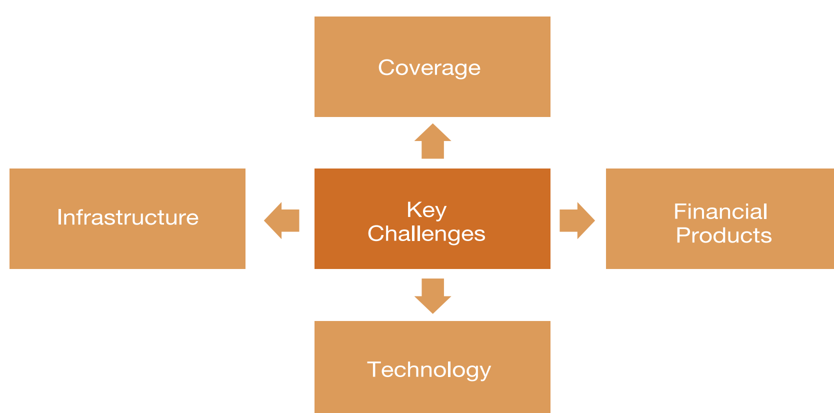
However, there are some key challenges that are being encountered in the drive to achieve financial inclusion, more particularly the following:

- **Coverage** - The huge population of India makes it cumbersome for any program to be completely inclusive. Especially in the case of migrant labour, money flows freely through unorganized channels, making it difficult to keep an account.
- **Infrastructure** – Infrastructure development in India has not kept pace with the economic growth in the country and lags behind to a great extent. It is essential to develop road, rail, digital connectivity and adequate power and infrastructure facilities which are important prerequisites for operation of a banking outlet.
- **Financial Products** – Simplicity and flexibility of products are two basic constituents of financial products. These products should suit the requirements of the masses and be made available at affordable costs.
- **Technology** – Integrating technology in the banking system is essential to move a step closer to inclusive growth. The technology solutions offered, should be standardised, interoperable and cost effective. There is a high transaction cost associated with providing banking services in the rural areas. Technology, if used appropriately can help in reducing the cost of transactions by a considerable extent.

To overcome the obstacles to inclusive growth, efforts need to be channelised to identify an appropriate delivery or business model for financial inclusion. The traditional brick and mortar bank branches may not be a viable option for many of the villages, specially those situated in remote areas. Banks need to adopt a slow and tedious process of experimenting with all options of delivery models like satellite branches, mobile branches, business correspondents (BC), and mobile services.

Until now, the BC model has been observed as a strong facilitator, but their functioning needs to be scaled up considerably to prove effective in the long run. The Working Group appointed by the Reserve bank to review the BC model has recommended new entities that could be appointed as BCs. Coupled with Information and Communication Technologies (ICT) solutions, this delivery model has the potential to reach out to the un-banked areas.

Figure 3: Some key challenges that are being encountered in the drive to achieve financial inclusion



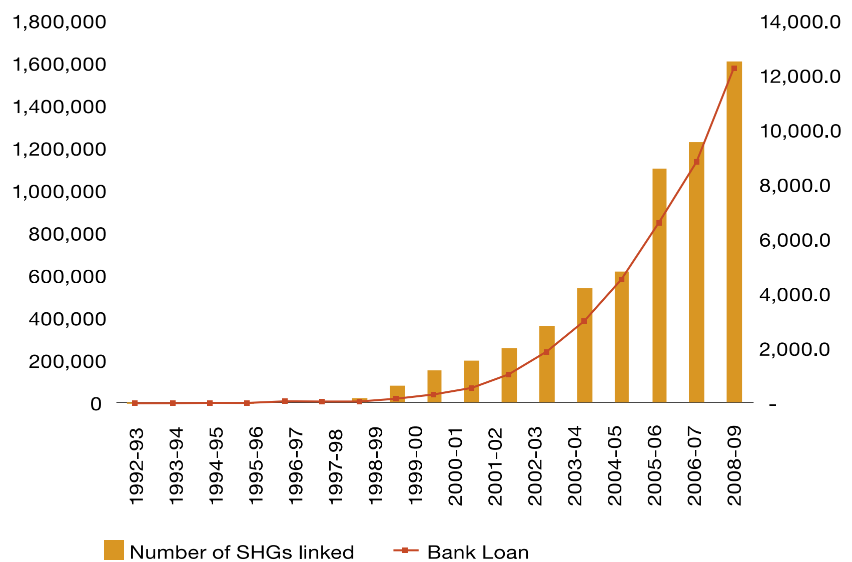
Regulatory Intervention as part of Financial Inclusion, is required to foster Inclusive growth

To make financial inclusion a reality, a strong regulatory framework is necessary to bring in financial stability, which can act as an enabler for this initiative. To aid financial intermediaries in delivering their services effectively to the low income group segment of the population, technology needs to be leveraged with economies of scale. Regulation of these entities succeeds in instilling confidence in lenders and investors, in bringing in more organized funding.

The points mentioned below discuss the incentive structure of financial inclusion within a prudential framework

- The success of credit unions and community banks across the world have succeeded in providing financial services to local communities, suggesting that smaller regional banks could be an ideal solution for financial inclusion. However, India's experience with local entities such as cooperative banks, deposit taking NBFCs and regional rural banks reflect poor governance, connected lending, geographic concentration indicating vulnerability to downturns.

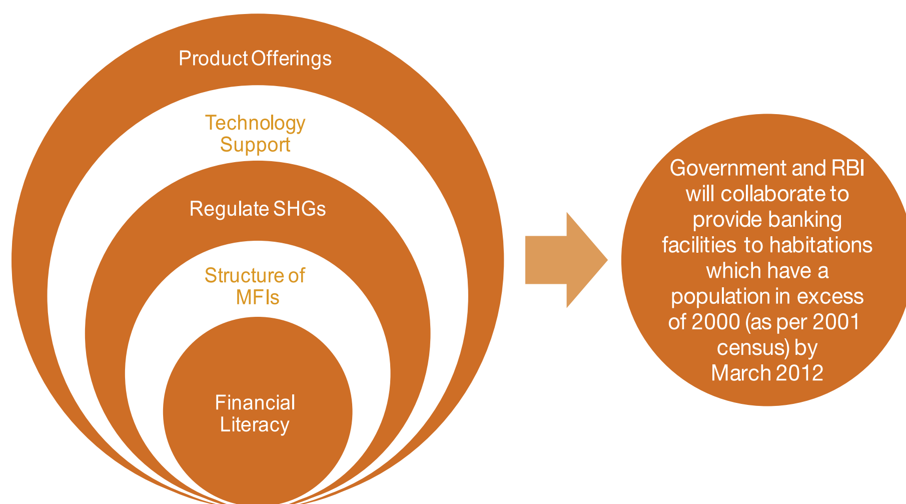
Figure 4: Progress of Self Help Groups



Source: RBI
Note: Bank Loan in Rs Crore

- In the early 90s, a transformational regulatory notification was issued which facilitated financial inclusion. Banks were allowed to open savings accounts for Self Help Groups (SHGs), which were neither registered nor regulated. The penetration achieved through SHGs over the years has been very significant (Figure 4). As per NABARD's report on status of microfinance (2008-09), about 86 million poor households are covered under the SHG-Bank Linkage program with over 6.1 million saving-linked SHGs and 4.2 million credit-linked SHGs as on March 31, 2009.

Figure 5: A sustainable way forward for taking Financial Inclusion to the next level



Proposal for New Banking Licenses to help inclusive growth

The finance minister in his Union budget announced that RBI will consider giving additional banking licenses to private sector players and NBFCs. This has been proposed with a view to increase geographical coverage, moving a step closer to financial inclusion. In addition, granting of new licenses will give a boost to competition, resulting in reduced costs and improved efficiency.

A draft discussion paper has been released by RBI to that effect, discussing the various criteria enlisting their pros and cons. Currently, RBI is holding discussions with various industry bodies to get feedback to the various options, mentioned in the said paper.

Some of the more important criteria which the RBI will be keeping in view would be:

- Business model for new banks
- Eligibility of industrial houses to promote banks
- Conversion to NBFCs to banks or NBFCs to promote a bank
- Cap on foreign shareholding

So, what would be a sustainable way forward for taking Financial Inclusion to the next level? (Fig.5)

- **Promoting financial literacy** - Use of creative adult learning techniques, and adequate investment in literacy programs to benefit the target group and the service providers.
- **Structure of MFIs (having shown very high growth rates)** – MFIs need a proper product design and model. They need to be well equipped with information on various products to pass it on to the target group. Also, in order to sustain MFIs and achieve the desired objective, accountability and credibility needs to be wedged in.
- **Regulate and monitor the SHGs (very good reach to the ultimate borrower)** – There is a need to measure and monitor the performance of SHGs. Regulation of these intermediaries will place inclusive growth on a better footing.
- **Technology support** – Inclusive growth cannot be achieved without the required technology support. The advent of mobile technology is being leveraged to reach out to the under-banked and the un-banked population.
- **Product offerings** – The product portfolio needs to be customized to cater to the requirements of the target group. Complex products needs to be avoided and offerings should be designed keeping in mind transparency, simplicity and flexibility. Credit products should be given priority over other products like insurance and savings.

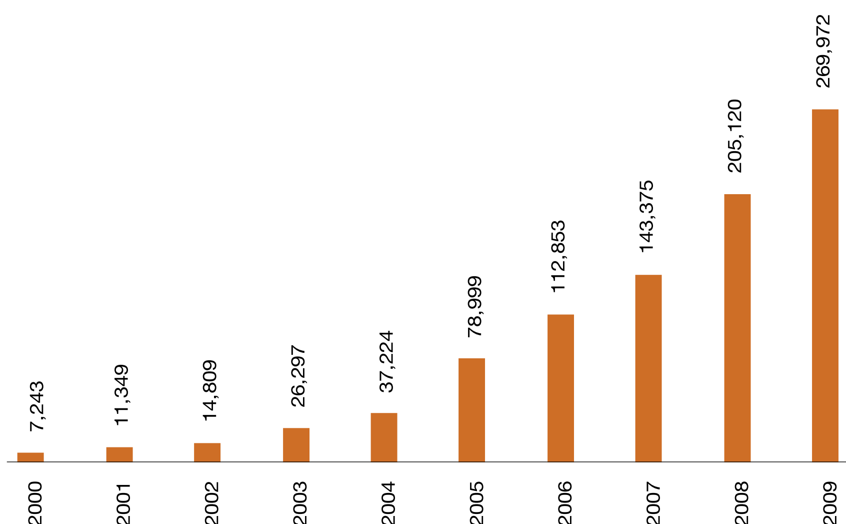
A well designed business model needs to be devised, in order to sustain a cost-effective delivery model for penetration in the rural areas. Banks need to refine and review their delivery models to ensure greater operating efficiency.

A well-developed financial system skewed towards banking inclusion plays an important role in economic development. Therefore, there is a need to develop a financial inclusion index, which will help evaluate the degree of achievement towards inclusive growth.

In a study done by the Indian Council for Research on International Economic Relations (ICRIER), in 2008, India ranks 50 in the index of financial inclusion. Referring to India, the ICRIER study said that although there was a low density of bank branches, the usage of banking system in terms of volume of credit and deposit seems to be moderately high.

Infrastructure Financing
Lending momentum to the growth of the Banking Sector

Figure 6: Bank Credit to the Infrastructure Sector (in Rs Crore)



Source: RBI
Note: Bank Loan in Rs Crore

Banks concentrate efforts on increasing their infrastructure financing portfolio

Bank credit to the infrastructure sector exhibited a steady growth from Rs. 7,243 crore in 1999-2000 to Rs. 2,69,972 crore in 2008-09, clocking a compound annual growth of 43.6% during the last ten years (Figure 6). Infrastructure lending has emerged as one of the focus areas for the banking sector, inspite of a slowdown in the overall growth of credit.

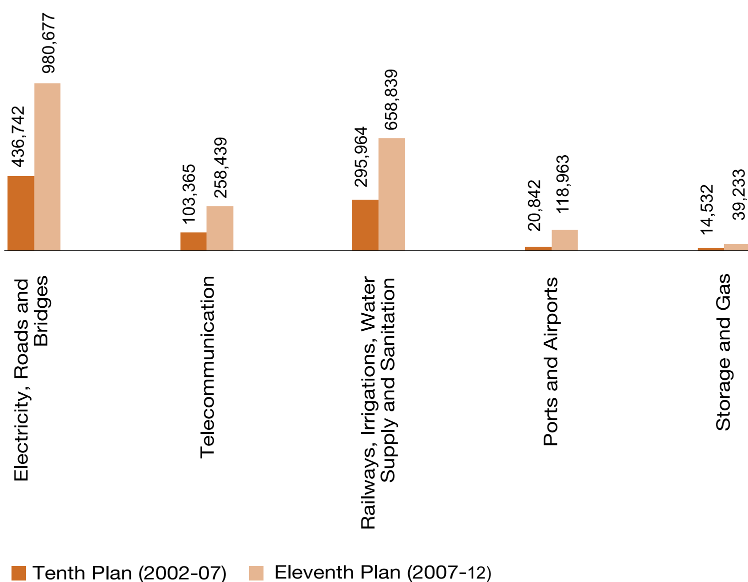
As per the data from the Reserve Bank of India in August 2009, banks showed a growth of 44.7% in credit flow to the infrastructure sector as compared with 36.1% in 2008. Infrastructure project developers are lapping up credit, and banks are focusing on this category of borrowers to enhance their balance sheets. However, there is a risk of exposure attached to banks with such long term financing considering the mismatches from an Asset-Liability Management perspective.

Prudential norms have been relaxed by RBI for infrastructure projects, but RBI is circumspect to allow further relaxations in exposure norms. It is important to note that infrastructure finance requirements cannot be met solely by banks and consequently, this sector needs long term finance support from insurance companies and pension funds.

Economic development thrives on support from development of infrastructure. Economic growth in India has been moderately high at 7.4% in 2009, expected to grow at 8.75% in 2010 and 8.5% in 2011 (IMF estimates). These figures indicate that for this growth to be sustainable, the demand for infrastructure needs to be adequately fulfilled.

Emerging economies attract huge capital flows, and thereby provide abundant opportunity to finance infrastructure projects in these countries, provided these are proved commercially viable. Currently, India spends only 6% of its GDP on provision of infrastructure, as compared to China which spends as much as 20% on infrastructure development.

Figure 7: Flow of Investment to various sectors (in Rs Crore)



Source: Planning Commission

Most of the infrastructure projects are financed by the government, but the role of the private sector has become increasingly important in enhancing the flow of funds and improving efficiency. However, as the returns attached to these projects are low, and carrying multiple risks and uncertainty, there arises a need to incentivise private investment.

Incentives for Private investment will determine the depth of fund flows

Typically, investments from private sources are high in only those sectors where the user cost is structured and defined, and it is easy to retrieve the costs. For the remaining sectors, it is primarily the public investments that cater to the infrastructure provisions, given their importance in the economy. Some of the sectors like irrigation, water supply, electricity and gas are the specific cases where user charges need to be defined and contract enforcement mechanisms need to be strengthened further, to ensure an uninterrupted flow of investments from private sources.

Recently, there has been some notable progress in attracting private investment in the infrastructure industries. The financing requirement from the private sectors during Eleventh Five Year Plan is estimated to be over 30% from a little less than 20% during the Tenth Plan period. Figure 7 illustrates investment flows to various sectors in the tenth and eleventh plan.

Investment in infrastructure in the first 3 years of the Eleventh Plan Period has exceeded the target of Rs 981,119 crore. The actual investment was recorded to be Rs 1,065,828 crore, which is 7.1% of the GDP and 109% of the targeted expenditure. During this period, investments in sectors such as electricity, telecommunications, irrigation and oil and gas pipelines have exceeded the target.

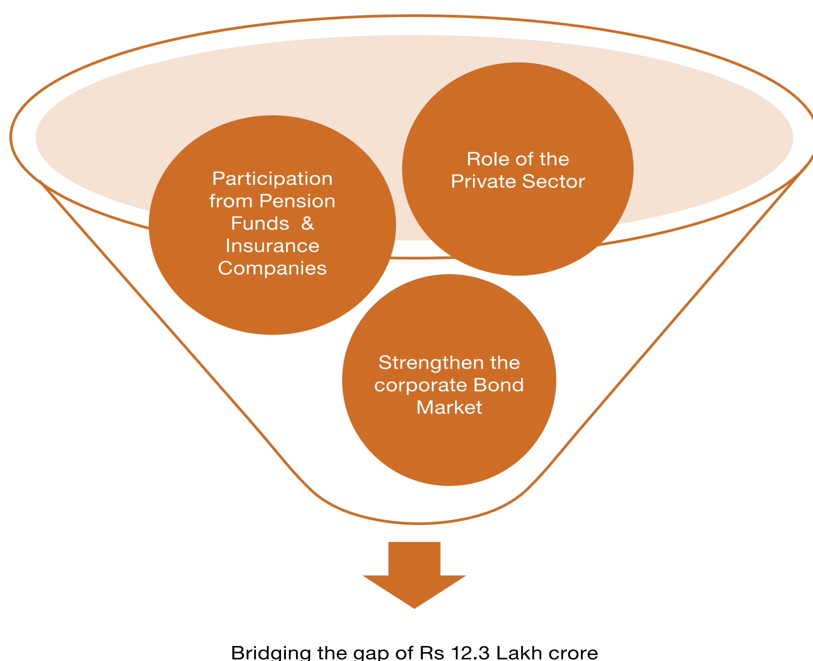
The plan for infrastructure investment during the Twelfth Plan (2012-17) period is estimated to be about Rs 41 lakh crore, which is a quadruple increase from the existing investment. However, in the Twelfth plan period, there is an expected gap of 30% in financing infrastructure projects.

The Road ahead for Infrastructure financing:

Some of the ways in which the deficit in financing can be bridged are as follows:

- **Participation from pension funds and insurance companies –** Bank lending to the infrastructure sector exhibits an asset liability mismatch and entails risk issues. Pension funds and insurance companies are

Figure 8: The Road ahead for Infrastructure financing



exploring new asset classes to match long-term requirements and provide diversification; hence involving pension funds and insurance companies for funding these projects would prove more viable in the long run. A mechanism needs to be carved out to channel the resources of pension funds into infrastructure financing.

- **Role of the private sector** – The private sector needs to complement the government's efforts towards development of infrastructure. There is a requirement to develop infrastructure sectors, like power, telecommunications, irrigation, transport, housing, commercial complexes, water supply, sanitation and other urban amenities. It is difficult for the Government alone to develop, upgrade and meet the infrastructure needs; hence the private sector should play a pivotal role to bridge the gap between demand and supply.

- **Strengthen the corporate bond market** – There is a need to strengthen the corporate bond market and develop credit enhancement mechanisms to enable infrastructure projects access long term funds. Going ahead, increased flexibility for such bonds to be issued by banks or introducing Zero Coupon Bonds for infrastructure with income tax benefits, are some of the incentives that can be meted out.

The Deepak Parekh Committee on India Infrastructure Debt Fund (IIDF) has given certain recommendations towards regulatory changes to permit foreign insurance and pension funds to invest in the proposed IIDF. The committee proposes that the IIDF be set up and managed as a trust, with an intial corpus of Rs 50,000 crore, approved and regulated by SEBI. These recommendations follow from similar practices followed in the US where three institutions - National Infrastructure Bank (NIB), a National Infrastructure Development Corporation (NIDC) and a subsidiary National Infrastructure Investment Corporation (NIIC) were established to raise money from the market as long-term debt, and then fund public and private investments in infrastructure.

Indian Capital markets
A fertile ground for growth of the financial sector

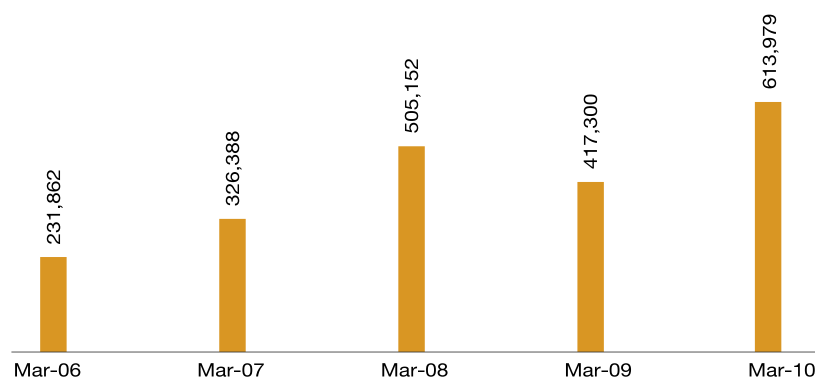
Capital markets in any country play a pivotal role in the growth of economy and meeting the country's socio-economic goals. They are an important constituent of the financial system given their role in the financial intermediation process and capital formation of the country. The importance of capital markets cannot be under-emphasised for a developing economy like India which needs significant amount of capital for development of strong infrastructure.

Just to give some perspective, it is estimated that India will require capital flows of USD 500 billion merely for developing its infrastructure. The Indian economy's current size is approximately USD 1 trillion in 2009-2010 with the savings rate of Indian households of 33.4% in 2009 -2010. In the next decade or so, it is expected that the economy will grow at an average rate of 8%. This translates into incremental savings of USD 5 trillion over the next decade. Comparatively, the US economy's current size is around USD 13.22 trillion in 2010. Assuming a savings rate of 5%, it may not be a surprise if the amount of savings of Indian households exceeds savings of US households in absolute terms by 2020.

Also, Indian households have traditionally preferred safety of bank deposits and government saving schemes and much less than 10% of the their investments in financial assets is in shares, debentures and mutual funds, which is very low as compared to some of the developed economies. Given the

Indian households have traditionally preferred safety of bank deposits and government saving schemes and much less than 10% of the their investments in financial assets is in shares, debentures and mutual funds.

Figure 9: Growth of Assets under Management (in Rs crore)



Source: AMFI

quantum of savings, the need to mobilise savings into productive channels and the opportunity for financial intermediation, the next decade will be an opportunity of a lifetime for Indian capital markets players.

The Government, the Regulators and the financial institutions have an important role to play in building a strong and robust capital market. The growth trajectory of a country's capital markets in significantly influenced by the actions of these stakeholders. Concerted efforts of the Government and the Regulators supported by a long-term vision and clarity in action can significantly help in fostering a climate that is conducive to growth and investments.

Before diving deep into the 2020 roadmap, it may be useful to pause and better understand the functions of an efficient capital market. Such functions comprise -

- Mobilize capital from suppliers of capital;
- Create a platform to facilitate exchange of capital through buying and selling of securities and other asset classes;
- Facilitate price discovery in a quick and transparent manner;
- Facilitate settlement of transactions;
- Protect rights of the investors.

Components of the Indian Capital Market

In light of the above backdrop, this section of the report broadly analyses the current Indian Capital Markets, their constituents and the impetus required, especially from a regulatory perspective to take the capital markets to the next level. This report is divided into the following segments:

- Equity Markets
- Debt Markets
- Commodity Markets
- Currency Markets

Equity Market

The equity market comprises of the primary market and the secondary market with key constituents being Domestic Institutional Investors such as mutual funds and insurance companies like LIC, Foreign Institutional Investors and retail investors who directly participate in the capital markets.

Domestic Institutional Investors

The size of the Indian Mutual Fund industry (comprising both, equity and debt funds) is estimated at USD 162 billion.

Since the 1990s when the mutual fund space opened up to the private sector,

the industry has traversed a long path. Assets under Management have grown at a CAGR in excess of 25% over the last four years, slowing down only over the last two years, as fallout of the global economic slowdown and financial crisis (Figure 9).

As a Regulator focused on protecting retail investors' interests, SEBI has done a commendable job with the changes it has introduced in the regime in recent past such as abolition of entry load, abolition of additional management fee for schemes launched on "no load" basis, compliance with documentation/KYC norms, transferability of units of mutual funds, etc.

However, the industry continues to be plagued by low margins and stiff competition from other investment products such as those offered by of the life insurance industry and the portfolio managers. To develop the industry in a manner that is fair to all the stakeholders of the industry, amongst others, the following suggestions could be considered –

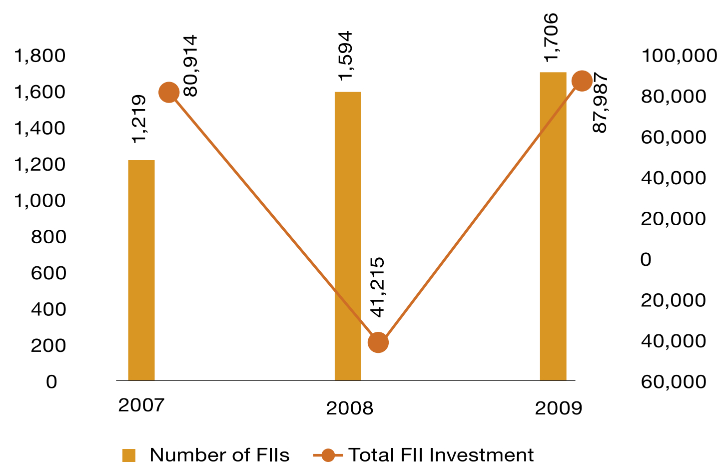
- Allowing Asset Management Companies the flexibility to charge management fees. In a "perfect competition" scenario, the price of goods or services is efficiently determined by the market itself. There are more than 35 asset management companies with many other in the pipeline. Over a period of time, the market should be able to price the services provided by asset management companies in an efficient manner such that their interests are also protected.

- Mutual fund distributors in India are largely unregulated. Further, there are instances of distributors rendering investment advice without requisite qualification, information of mutual fund schemes/investor and consideration of the investor's needs. Distribution supported by quality investment advice is clearly the need of the hour. Herculean effort is required and the entire asset management industry should work towards this goal. Regulation of the distributors by a Regulator can be a point worth debating. More importantly, SEBI should strongly reach out to create/support infrastructure to train the distributors to meet the needs of the investors.

- There are a plethora of similar sounding schemes offered by the asset management companies resulting in a craving for lower number of schemes with similar investment strategy. Unfortunately, that is only one side of the story. The products are not innovative and offer limited asset classes with inadequate opportunities for diversification. SEBI and the mutual fund industry need to work towards amending mutual fund regulations and offering

SEBI and the mutual fund industry need to work towards amending mutual fund regulations and offering more diversified products

Figure 10: Transaction of FIIs



Source: RBI; Note: Total FII investment in Rs Crore

more diversified products such as Real Estate Mutual Funds, which despite enactment couple of years ago have not seen the light of the day! This will help in optimising the utility of mutual funds as well.

- As regards investment by pension funds, the current regulations allow only about 10 percent of the pension fund corpus to be invested in the equities market directly or through mutual funds. In contrast, internationally, up to 50 percent of pension funds are permitted to be invested in equities. Also there are certain restrictions on the exposure of insurance companies to the capital markets which reduces the much needed inflow of long term investments into the capital market. Moving the Indian pension funds and insurance companies closer to international levels could give a much needed boost to domestic institutional investor participation.

Foreign Institutional Investors

The number of FIIs/sub-accounts and the amount invested by them in the Indian capital markets is a reflection of the potential of the Indian economy. In the last decade, the investment by FIIs/ sub-accounts has multiplied 7 times and in the current fiscal (in the first half), it has already topped USD 12,289 million.

From time to time, SEBI has brought in changes which have supported the growth of investments by FIIs/sub-accounts. Some of the key changes include -

- Qualified Institutional Buyers defined to include FIIs.
- Allowing FIIs to invest in debt markets including corporate debt, government securities and security receipts issued by Asset Reconstruction Companies.
- Permitting stock exchanges to allow Direct Market Access ("DMA") to institutional clients. An institutional investor can access broker's system from its office and can book orders directly into the system. In DMA, the brokers' infrastructure is bypassed. However, the trade and settlement obligations will continue to apply to the broker, as will the risk management compliance, which involves payment of margins and exposure limits arising from orders and trades in the DMA. The DMA system helps in better and faster execution of orders with avoidance of leakage of sensitive information of trades.

With a population of more than a billion, a mere 1% of the population participates in capital markets, and of that only a fraction is active.

The concessional taxation regime for listed securities and for FIIs has also supported the growth of FII investments though more certainty around the taxation consequences and eligibility of treaty benefits is desirable.

A key change that could bring a paradigm shift in the asset management industry is allowing domestic fund managers to manage funds raised from offshore investors for investment in India. But for a taxation issue, such funds are being currently managed from more tax efficient jurisdictions such as Singapore. If the taxation regime were to be amended to provide for "safe harbour" rules exempting foreign funds from Indian taxation (in a manner similar to Singapore), then, the asset management industry would grow exponentially.

Retail investors

One of the daunting challenges before the Indian capital markets is expanding the investor base and provides them access to high quality financial services. With a population of more than a billion, a mere 1% of the population participates in capital markets, and of that only a fraction is active. Trading volumes in Indian Capital Markets are lower as compared to other markets such as United States, the United Kingdom, Germany, China etc.

Similarly, Indian households invest much less in equity markets than do their developed market counterparts, particularly in the United States and the United Kingdom. As a result, retail equity ownership (non-promoter) amounts to only around 10 percent of total equity ownership, and has come down by 3 per cent over the last seven years. While corporates see markets to raise low cost risk capital, investors see liquid secondary markets for exit options. The regulated markets have grown significantly, but the markets need greater depth and liquidity.

Another challenge faced by the investors is the costs involved in trading (brokerage, commission, taxes etc.), which are comparatively higher in India than in developed markets. The investor participation is fairly shallow considering the size of the economy.

In order to overcome the above bottlenecks and to deepen the capital markets, participation of retail investors, directly and through intermediaries such as mutual funds and portfolio managers needs to be further promoted. This can be achieved only through investor education initiatives, development of quality independent financial advisors and using the Information Technology to reach out across the length and breadth of the country.

Other aspects

Indian Depository Receipts ("IDRs")
IDRs are instruments in the form of depository receipts created by a depository in India against the underlying equity shares of the issuing foreign company. IDRs are an important step towards integrating Indian capital markets with foreign markets and enabling Indian investors to hold stake in foreign securities.

For various reasons, IDR have taken more than couple of years to be operationalised. Also, there are certain unresolved tax issues relating to taxation of income from IDRs. For example, the concessional tax regime for listed securities does not extend to IDRs. Also, there is no clarity on taxability of conversion of IDRs into underlying foreign equity shares.

Further, IDRs could be made more attractive by introducing two way fungibility of IDRs and removing the mandatory lock-in of a year for conversion of IDRs into equity shares of the foreign company.

Securities Lending and Borrowing ("SLB") Scheme
SLB facilitates short-selling, increasing liquidity, improving pricing and arbitrage between derivatives and cash markets. SEBI amended the SLB scheme in January, 2010 with a view to make short-selling more accessible to investors. This move provides the investors including FIIs to have greater opportunity to access the Indian

securities market. However, there are certain issues revolving around this amendment like the use of stock lending by promoters, applicability of insider trading regulations and the takeover code.

In case of corporate action in SLB contract period, the lending and borrowing gets suspended. This condition should be relaxed.

Insurance companies should also be allowed to lend their securities, which is currently not permitted.

Presently, very high margins are required to be maintained under the SLB. SEBI should consider relaxing the same in the due course.

Small and medium size Enterprises ("SME")

Currently SMEs contribute 17% to India GDP and as per survey by ASSOCHAM; it is likely to be 22% by 2010. SMEs play an important role in the economy but their contribution to the main financial market is low. SMEs face a road block in the form of high cost of raising capital. SMEs lack access to formal capital market due to low credibility and low profitability.

In order to enable Small and Medium Enterprises to raise finance through Capital Markets, SEBI has proposed to encourage promotion of dedicated exchanges and / or dedicated platforms of the exchanges for listing and trading of securities issued by Small and Medium Enterprises ("SME"). Certain relaxations are provided to the issuers whose securities are listed on SME exchange.

SMEs seeking to list on stock exchanges need not have a track record of a minimum of three years in making profits and paying dividend

To ensure success of a SMEs-designated exchange, SEBI has proposed several incentives not available to other exchanges. The most striking one relates to doing away with Disclosure guidelines for SMEs. This means that SMEs seeking to list on stock exchanges need not have a track record of a minimum of three years in making profits and paying dividend. Doing away with this guideline is indeed a positive move toward the promotion of SMEs exchange as many SMEs might not have operated for the required number of years.

Further, to speed up the listing process and give greater flexibility to the disclosures made in the offer document, SEBI has also proposed that it would not

The SME exchange could prove to be a landmark development and help in promoting the vibrancy of our capital markets.

vet the offer document. But the challenge before SEBI is to attract enough investors as many of them, because of fewer disclosures norms, may act cautiously while subscribing to shares of these companies.

Some concession is also proposed to be given to companies to reduce the cost and strain of publishing quarterly results. Thus companies seeking listing on the SMEs exchange will be allowed to publish their results every six months. While this measure will surely give a fillip to companies' interest in listing on the exchange; it would have to be ensured that it doesn't lead to excessive drop in investors' interest owing to an increased risk perception.

The SME exchange could prove to be a landmark development and help in promoting the vibrancy of our capital markets.

Exchange Traded Derivatives

Exchange traded derivatives like options and futures are hedging tools, used especially in a bearish market with lower transaction cost as compared to some of the other instruments. Since they are exchange traded, their pricing and volume transacted are transparent and are highly liquid. However, there is a risk of adverse price movement resulting into losses.

The trading of foreign exchange traded derivatives has emerged as very important financial activity all over the world just like trading of equity-linked contracts or commodity contracts. India's ranking in the global exchange-traded derivatives market continues to rise. According to latest volume rankings for the first half of 2010 by the Futures Industry Association (FIA), National Stock Exchange (NSE), India's ranking has improved by two places and it's now the fifth largest derivatives exchange in the world.

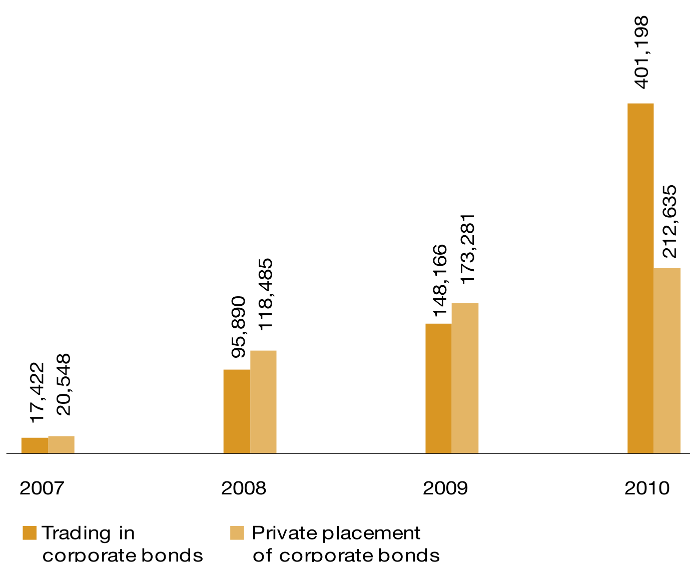
SEBI recently allowed physical settlement in equity derivatives and subsequently the Bombay Stock Exchange (BSE) also decided to replace the decade-old cash settlement procedure in the equity derivatives segment with physical settlement as a mechanism for better price discovery. SEBI's nod for physical settlement is a regulatory response to the vulnerability of domestic markets and is perhaps aimed at ring fencing the stock markets from excessive shorting, which can often bring stock markets crashing down. Basically, it is a move to check excess volatility in the underlying cash market.

Proposed Takeover Code

SEBI constituted the Takeover Regulations Advisory Committee ('TRAC') in September 2009 to suggest recommendations for amending the existing Takeover Code. TRAC submitted its report to SEBI which is currently open for public comments. It recommended major changes in regulations in India, including raising the open offer size to 100 per cent. Increase in the open offer would make takeovers more costly under the new rules. The cost of acquisition would also surge. But, from a shareholder's perspective, the new rule is a big positive as it will give all shareholders an option to exit during the open offer.

The other major change includes the threshold to trigger the takeover code to 25 per cent. This is likely to open financing options for corporates. This would make it easier for companies wanting private equity money to raise the cash without attracting open offer provisions, up to 25 per cent.

Figure 11: Trading of Corporate Bonds (in Rs Crore)



Source: RBI

Public Issue Regulations
SEBI notified the SEBI (Issue of Capital and Disclosure Requirements or ICDR Regulations, 2009) repealing the erstwhile SEBI (Disclosure and Investor Protection or DIP Guidelines, 2000). The ICDR Regulations attempts to streamline the framework for public issues by removing unnecessary stipulations, introducing market-driven procedures and simplifying the clutter of legality.

Minimum Public Shareholding
The Ministry of Finance recently brought the minimum threshold of public shareholding for all listed companies to 25%. The amendment was a move towards providing better liquidity to public shareholders and to reduce the scope of price manipulation.

Debt Market

Corporate and Government Bonds
In developed economies, bond markets tend to be bigger in size than the equity market. A well-developed capital market consists of both the equity market and the bond market. In India, equity markets are more popular and far developed than the debt markets.

The Indian debt market is composed of government bonds and corporate bonds. However, the government bonds are predominant (constituting 92% of the volume) and they form the liquid component of the bond market. An active corporate bond market is essential for India Inc. The corporate bond market is still at the nascent stage.

Although we have the largest number of listed companies on the capital market, the share of corporate bonds in GDP is merely 3.3%, compared to 10.6% in China 41.7% in Japan, 49.3% in Korea among others. Further, close to 80% of corporate bonds comprises privately placed debt of public financial institutions. The secondary market, therefore, has not developed commensurately.

Though there has been an increase in the volumes, the trading activity is still negligible in the secondary markets. If we look at the ratio of secondary market volume to primary market volume, the ratio is below 1 indicating very low trading activity in the secondary market.

Over the past few years, some significant reforms have been undertaken to develop the bond market and particularly the corporate bond market

SEBI has made efforts to facilitate trading of corporate bonds on the stock exchange platforms, however, government securities trading have turned out a better performance owing to several structural changes introduced by the Government and RBI.

Over the past few years, some significant reforms have been undertaken to develop the bond market and particularly the corporate bond market. The listing requirements for corporate debt have been simplified. Issuers now need to obtain rating from only one credit rating agency unlike earlier. Further, they are permitted to structure debt instruments, and are allowed to do a public issue of below investment grade bonds. One more welcome change was, the exemption of TDS on corporate debt instruments issued in demat form and on recognized stock exchanges.

Data released by SEBI indicates that companies raised Rs 2.12 lakh crore through corporate bonds in 2009-10, up 22.71% from Rs 1.73 lakh crore in 2008-09 (Figure 11). India has witnessed a boost in trading in the recent past. Total trading in corporate bonds more than doubled from an average of Rs. 1,550 crore in October 2009 to Rs 3,356 crore in March 2010, as reported by the National Stock Exchange and the Bombay Stock Exchange.

In view of the current macroeconomic environment in India, the Indian government increased the FII investment limit in Government Securities and Corporate Bonds by USD 5 billion. Increased limits would open up new avenues for FII investment in debt and cater to the growth of debt markets in the country.

In a recent move, SEBI has stipulated that all trades in corporate bonds would now be routed through stock exchange platform. This would help in reducing settlement risk and reduce transaction costs. At the same time the exchanges would document the trades, thus creating transparency as well as assist in price discovery. The transparent dissemination of corporate bond prices and quantities traded will also facilitate better participation by market participants.

Based on the feedback received from market participants, SEBI also relaxed the exposure margin requirement for stock derivatives.

The challenges involved in developing the bond market in India include generating demand from domestic investors along with boosting market infrastructure and rationalizing the taxation regime. A liquid secondary market is necessary as investors get easy exit route. However, we do not have an active secondary market too. The exchange market is not active and the market is largely OTC.

The price of bonds is influenced by cost of rating, listing and marketing which makes them costly for investors. Stamp duty rates for primary issue of bonds are very high and differ from state to state.

Other markets have a much more diversified mix, with interest rate futures, foreign exchange futures and corporate bonds accounting for a sizable share of exchange trading. Deeper corporate debt markets also provide the required support to make a balanced capital markets.

Effective reforms in corporate debt market could help support the growth of overall capital markets. Some of them have been listed below:

- Required changes that can lead to the expansion of the Corporate Bond market would be - means to uniform stamp duty, screen based trading, clearing house settlement, increase in secondary market activity and thereby assist in transparent price discovery and avenue for early exits for investors and consequently also lead to more Issuers of long tenor debt.

- The investment guidelines of provident and pension funds for investing in corporate bonds are stringent and biased towards category of issuers. There should be a gradual relaxation of investment restrictions and forced rule based buying on long-term investors such as insurance companies, pension funds and Banks. This will give the required flexibility in deciding the investments based on its merit. The insurance and pension segments will be crucial not just for increasing social security, but are also likely to emerge as a catalytic factor in development of long term debt markets in India, a crucial feature for the massive financing needs for infrastructure projects.

- Consolidation of existing series of Government bonds to improve liquidity and facilitate better price discovery

- Relaxing FII limits for corporate bond participation when needed. Allow greater participation for FIIs (Not just limited by their exposure) as it will help create liquidity

- Interest-rate derivatives are needed to hedge rate risks, the largest macro-economic risk. Make interest rate futures available on a broader range of securities (both long- and short-term)

- Introduce interest rate options to attract a wider investor base

- Credit trading is an essential prerequisite for the development of the corporate debt market. Regulatory reforms are required in this space keeping in mind the learnings from the International space.

- The current withholding tax of 20% should be removed to encourage investors to invest in debt securities.

Islamic Bonds and other Shariah compliant investment products
Another debt instrument that has gained popularity in the worlds markets since 2007 is the Islamic Bonds. Islamic Bonds are asset backed interest free bonds. Islamic finance does not involve payment of interest and is based on sharing of both profit and loss. In India, the concept of Islamic bonds and other Shariah compliant products is yet to take-off but it certainly has immense potential.

The RBI should take the lead to encourage efforts to enhance the legal and regulatory framework required for Islamic finance to ensure uniformity with international practices. Also, steps

to be taken for creation of awareness within the financial system and investor community and engage Shariah advisors to provide consensus, guidance to uphold Islamic financial products and structures.

Commodity markets have traditionally been quite volatile. It is important to allow institutional investors to invest in commodity markets as they bring significant trading experience.

Commodity Market

Commodities are emerging as an important asset class that can help market savvy investors diversify risks. The commodity markets have been growing at a phenomenal pace, as evident from the number of commodity exchanges set-up and proposed to be set-up (pending approval from the Regulator). In addition to augmenting capital markets, commodity markets have an important role to play in development of a country's agricultural sector and related eco-systems.

Commodity markets have traditionally been quite volatile and hence, it is important to allow institutional investors to invest in commodity markets as they bring significant trading experience. Internationally, there are different ways in which mutual funds invest in commodity markets. Domestically, gold is the only commodity where retail investors can participate. Further, presently, other investors such as FIIs, banks, etc. are not permitted to invest in the commodities markets. These investors should be allowed to take exposure in commodity markets. If there are any concerns around excessive speculation, then, the same could be addressed by limiting exposures to certain amounts/ percentages, etc. or through other methods.

A key element for development of commodity markets is the presence of a strong regulator. Currently, the Forward Markets Commission ('FMC') acts as the regulator. As compared to SEBI, FMC has limited autonomy in making regulations or policy changes. The Bill to grant additional authority to the FMC has been pending enactment for several years now. It is imperative to pass the law as it will lead to the strengthening of the FMC and the commodity markets.

Currency Market

The currency derivatives segment on the NSE and MCX has witnessed consistent growth both in traded value and open interest since its inception. India already has an active over-the-counter (OTC) market in currency derivatives. The exchange-traded currency futures market is an extension of this already available OTC market, but with added benefits of greater accessibility to potential participants; high price transparency; high liquidity; standardised contracts; counterparty risk management through clearing corporation and no requirement of underlying exposure in the currency. As the market participants are realising these benefits of exchange-traded market in currency, they are choosing this market over OTC.

Stock exchanges in India will also be launching Options in Currency Derivatives soon. The RBI and SEBI have given in principle clearance to launch options in Currency Derivatives. Similarly, the Currency market should provide for diversified products such as futures and options on cross currencies and currency ETFs.

The Way Forward for the capital markets

Summarised below are some recommendations which could move Indian capital markets closer to efficiency and scale greater heights -

- Investor education and regulation of mutual fund distributors
- Allowing AMCs the flexibility to charge fees
- Innovative products across different asset classes including operationalisation of REMFs
- Amending tax regime to encourage domestic AMCs to manage foreign funds from India
- Allowing higher investment by domestic institutional investors such as insurance companies, pension funds and provident funds to make investments in capital markets
- Make tax regime friendly for issuers/ investors of IDRs
- Make implementation of proposal of SME stock exchange effective
- Reduction in the current withholding tax of 20% on income from debt securities to encourage investment in debt market
- Developing a legal and regulatory framework for Islamic finance and structure new capital market products that are Shariah compliant
- Allowing institutional investors to participate in commodity markets
- Strengthening the autonomy of the FMC

Conclusion

Opening up of the financial markets has resulted in competition and greater efficiency; however, foreign participation could also bring in the baggage of increased risk and exposure as recent events have shown

The year 2009-10 was marked by the stabilising operations of regulatory bodies in various segments of the financial market, with the support of a resilient regulatory framework. All measures and initiatives undertaken were dedicated to strengthen the financial market, while increasing reach and accessibility by introducing new range of product offerings, enhancing transparency and liquidity in the financial system.

The contours of the financial markets are expanding with the advent of new technology, innovations in products and fast changing customer expectations. The Indian financial services sector comprises a good blend of domestic and foreign participants. Opening up of the financial markets has resulted in competition and greater efficiency; however, foreign participation could also bring in the baggage of increased risk and exposure as recent events have shown. Stability is therefore a critical need for financial markets for which safeguarding mechanisms need to be established, to prevent systemic risks and absorb shocks.

The equity market in India is extremely vibrant, but equity based funding solely, cannot lead the economy to growth. The debt market remains under-developed, with a huge potential for increased activity. A strong bond market is required to drive long term financing of infrastructure, housing and private sector development. The role of capital markets is vital for enhancing growth in wealth distribution and increasing availability of funds for infrastructure development.

One of the underlying challenges that the banking and financial services sector is dealing with is the issue of increasing the out-reach & enhancing financial inclusion. The huge scale of the drive towards inclusive growth is intimidating, as various stakeholders like banks, insurance companies and asset management companies struggle to move a step closer to the untapped areas and newer target consumers. The challenge lies in devising a cost-effective delivery model to reach out to the low income group of society, penetrating the remote areas. A debate on new banking licenses, banks developing and formulating strategies for inclusive banking and an increasing thrust on infrastructure financing, have been some of the initiatives which have been taken to give an added impetus to financial inclusion.

The road ahead for deepening the financial markets needs to be paved by the formulation of a strong linkage between the development of the economy and the capacity of the financial system. The global financial environment is moving towards an integrated financial system, and will serve in good stead to standardise compliance norms and procedures. A greater measure of transparency is also required to be built into regulatory procedures, to bring in a new dimension to financial markets, and take it to the next level.

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