

Key to double digit growth

Indian Capital Markets







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Message

Over the last few years, SEBI has announced several far-reaching reforms to promote the capital market and protect investor's interest. Reforms in the capital market have focused on three main areas: structure and functioning of stock exchanges, automation of trading and post trade systems, and the introduction of surveillance and monitoring systems. Today barely 2% of our population can actually access the capital market. To enhance investor participation, ASSOCHAM has initiated awareness programs and workshops in association with Ministry of Corporate Affairs as well as Exchanges, working in close cooperation with SEBI to make this project effective. Time is also ripe to rollout more Stock Exchanges to cater to our growing capital needs, in particular encourage setting up of trading platforms at the existing Stock Exchanges, in securities of SMEs. There are certain issues with new Takeover Code as well.

SEBI has also taken several proactive measures to improve the integrity of the secondary as well as primary markets through better governance and disclosure norms. However certain emerging challenges as well as regulatory reforms are still on the radar for smoothening out for wider and deepening participation of market participants.

In view of extensive expansion of Capital Markets in India which has been a key factor for consistent growth of our economy, ASSOCHAM has come out with a study paper jointly with PricewaterhouseCoopers on "Capital Markets – Key to Double Digit Growth", to identify the emergent issues and explore for the solutions for increasing the content as well as extent of capital markets.

I not only wish the Summit a great success but also assume that ASSOCHAM shall continue to organize such programs for larger public benefits with greater degree of excellence. ASSOCHAM extends earnest thanks to PricewaterhouseCoopers as our knowledge partner in this conference and also thanks to industry partners and 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

Capital Markets in India are characterised by its vibrant equity and debt markets assuming a fast paced growth. With domestic savings and investments pegged at a higher rate every year, capital markets strive to channelise the maximum savings into the financial system, thereby increasing the depth of the markets. There arises a need to create a suitable mechanism aided by appropriate instruments which will tap savings right from the grass root level, mobilising them into the capital market.

New vistas have opened up for the domestic players providing them with immense opportunities to gain a foothold in the International capital markets. Giving an added boost to the momentum of the capital markets is the flow of funds from FIIs, who refurbish their faith in the India growth story, by investing into the domestic market.

As Indian markets move a step forward to integrate with the global capital markets, financial stability and resilience assume increased importance. Most importantly, capital market reforms need to be aimed at establishing a robust regulatory framework and protecting the interest of the investor.

ASSOCHAM and PwC have prepared this report Indian Capital Markets: Key to double digit growth. This discussion paper aims to bring to the forefront some of the pertinent challenges and weak links in our domestic capital markets, while highlighting some of the strengths and emerging opportunities which play a critical role in accelerating the development of the capital markets. The report also touches some of the corporate governance practices and challenges, stressing upon the need for a resilient and prudent framework of governance.

We hope you will find this report insightful.

Jairaj Purandare

Leader - Financial Services
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Introduction



Despite the global economic downturn, Indian capital markets have done well in the last decade. Emerging markets are flush and have witnessed a steady inflow of funds from FIIs. A steady growth rate of GDP coupled with a high savings and investment rate, coupled with improved governance and favourable regulatory environment has built the momentum and kept the financial markets afloat.

As many economies recover from the aftermath of the economic downturn, buoyant markets in emerging economies are driving the shift of economic power from the west into the hands of emerging nations.

High liquidity levels in advanced economies have led to a sudden surge of capital flow to emerging economies. Favourable macro-economic



environment and interest rate differentials have attracted investments to the emerging markets. Statistics from BIS indicate that the cross-border lending of international banks to emerging Asian markets rose by US \$77 billion in the third quarter of 2010, up by 8.5%.

Although these capital flows have undoubtedly proven beneficial to these

economies, there is an inherent risk of exchange rate volatility and the formation of asset price bubbles. Liquidity in markets may be adversely affected because of this and may give rise to instability while dealing with inflationary pressures. Global economic imbalances have posed a huge challenge to policy-makers in creating a resilient macro-economic prudential framework. Policies need to induce and preserve domestic stability and build sustainability in the long run.

The changing landscape of financial markets brought about by evolving regulations, shift in consumer demand and changing demographics is re-defining the financial services industry. Complexities in financial markets are increasing, given the steady rise in the volume of products. Difficulties in comprehending the structure and quality of assets underlying the securities can lead to failure in complying with global standards thereby resulting in default. Some of the other factors which are adding to the pressure for domestic players are high customer expectations, intricate business models and continuously changing technology tools which span various products, infrastructure and channels.

Thus, the importance of increased domestic and global regulation has been recognised in this scenario of high volatility and globalisation of capital markets.

Heading for Growth

Indian Capital Markets



The year 2010-11 witnessed a strong recovery of Indian capital markets. This has set the pace for steady growth in the coming months. The vigour of the Indian capital markets reflects strong investor confidence and an increasing appetite for risk. Growth of the Indian economy was 8.6% during 2010-11, supporting the increased activity in the capital markets in full measure.

Net capital inflows increased to US\$123.2 billion in April 2011 as compared to US\$92.1 billion reported in April 2010. The composition of these capital inflows was dominated by (Foreign Institutional Investor) FII investments and trade credits, inflows from Foreign Direct Investment (FDI) being on the lower side.

Resource Mobilisation through the Primary Market				In ₹ Cr
	2008	2009	2010	2011
Debt	0	1500	2500	2197
Equity	54,511	2082	46,737	46,701
Of which IPOs	42,595	2082	24,696	33,068
Number of IPOs	85	21	39	40
Mean IPO Size	501	99	633	827
Private Placement	118,485	173,281	212,635	147,400

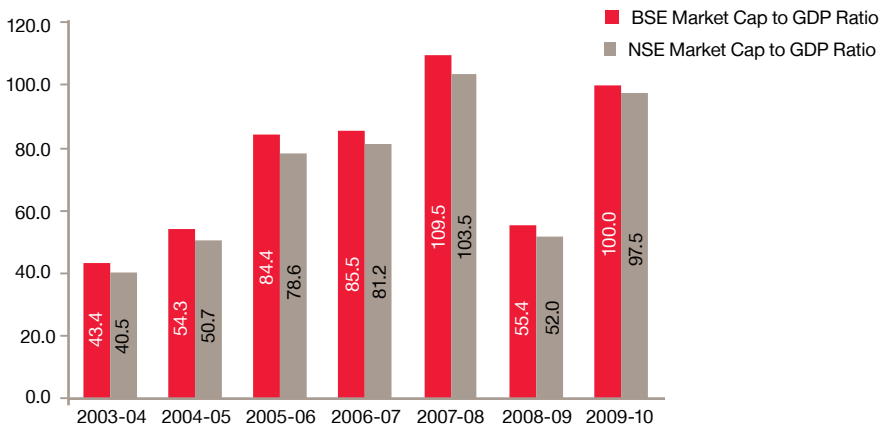
Source: Economic Survey 2011-12

In 2010-11, 40 new companies were listed on the exchange (NSE and BSE) at a consolidated value of ₹ 33,068 crore, as compared to 39 companies listed the previous year with a reported value of ₹ 24,696 crore. The amount of capital mobilised through private placement in 2010-11 as on November 30, 2010 was ₹ 1,47,400 crore, as compared to ₹ 2,12,635 crore in 2009-10.

Price appreciation has been reflected in the market capitalisation (of BSE) to GDP ratio and the traded value (of BSE and NSE together) to GDP ratio which increased from 55.4% and 69.1% respectively, in 2008-09 to 100% and 89.5% in 2009-10.

Resources mobilised through capital markets was ₹ 57,555 crore during 2009-10, as against ₹ 16,220 crore mobilised in 2008-09.

Market Capitalisation to GDP ratio (in %)



Source: SEBI Annual Report 2010

The derivatives market was equally buoyant in 2009-10. Turnover in the equity derivatives segment of NSE was ₹ 1,76,63,665 crore during 2009-10, an increase of 60.4% over 2008-09.

Turnover in the currency futures segment of NSE was ₹ 17,82,608 crore during 2009-10 as against ₹ 1,62,563 crore during 2008-09.

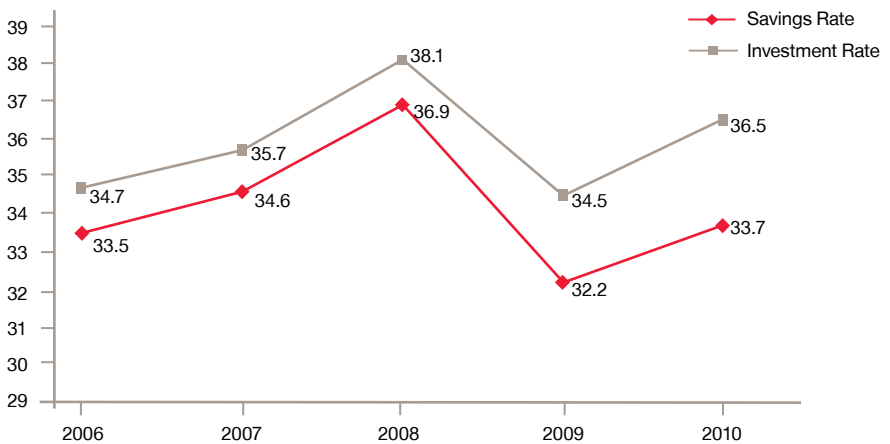
Trading on the mutual fund front was ₹ 62,959 crores as of April 2011, with an inflow of ₹ 9,629 crore in equity and ₹ 1,01,333 crore in the debt segment. Outflow as of April 2011 was comparatively lower at ₹ 48,466 crore than ₹ 65,372 crore reported in April 2010.

FII investment in the Indian market has maintained its momentum, with funds continuing to flow into the domestic market. The number of SEBI-registered

FII's stood at 1,713 by end-March 2010 from 1,635 a year ago. Net purchase in equities by FIIs was US\$ 23 billion in 2009-10 as against net sales of US\$ 10 billion in 2008-09.

This growth in mobilisation of resources has been spearheaded by a favourable macro-economic environment. A rise in savings and investment rate and steady growth in private consumption has created a favourable environment, giving a boost to the investment demand in the economy. The gross domestic savings rate currently stands at 33.7%, with the investment rate reported at 36.5%. The rate of saving in financial assets has also grown to 11.8% in 2009-10, a rise from 10.8% in 2008-09, reflected in the investment rate of the household sector at 11.7%.

Savings and Investment rate in the domestic economy (in %)



Source: Economic Survey 2011-12

Sustaining Growth Stock Exchanges



Stock exchanges play a critical role in the growth of capital markets, with infrastructure platforms like clearing houses, depositories, stock exchanges and commodity exchanges standing as the pillars in the financial markets. It is through stock exchanges that capital markets are able to trade with efficiency, adopt adequate risk management measures, establish transparent communication channels to benefit all stakeholders.

Deepening of the capital market can come about by integrating the regional exchanges with the national level exchanges, leading to higher yields, diversified risk and improved efficiency.

Dematerialising of shares by depositories and the initiation of online stock exchanges has helped to increase the accessibility of capital markets to the average investor. The number of companies which signed up for dematerialisation in NSDL grew from 7,801 in 2008-09 to 8,124 in 2009-10. At CDSL also, the number of companies that signed up increased from 6,213 in 2008-09 to 6,805 in 2009-10.

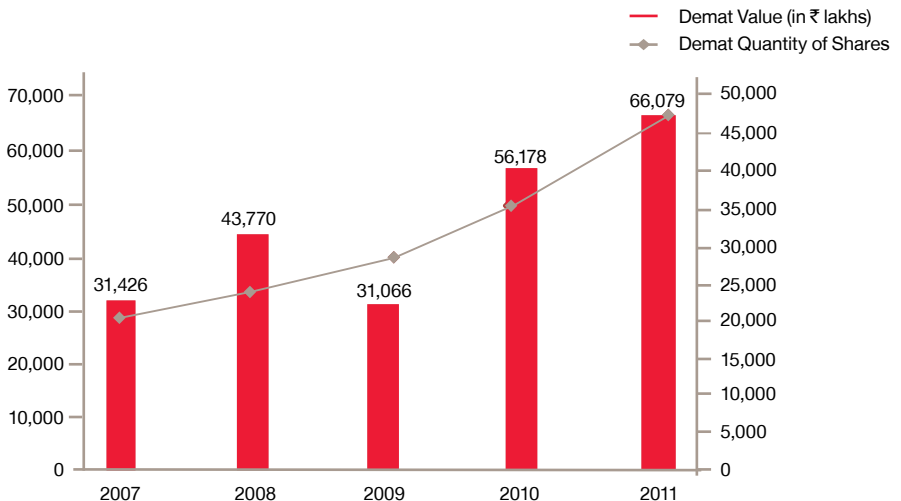
As an obvious offshoot of this growth, the number of dematerialised shares in NSDL went up by 24.1% from 28,287 crore in 2008-09 to 35,114 crore in 2009-10. As also in CDSL, the number of shares dematerialised increased 10.1% from 7,082 crore in 2008-09 to 7,795 crore in 2009-10.

Apart from shares, the dematerialisation facility is also extended to commercial paper and bonds. The objective is to increase coverage of trading through the exchange, thereby building on trading volumes.

The base of depository participants (DPs) of NSDL and CDSL broadened in 2009-10, with increase in geographical coverage. The DPs of NSDL were available in 1,255 cities in 2009-10 as compared to only 946 cities in 2008-09.

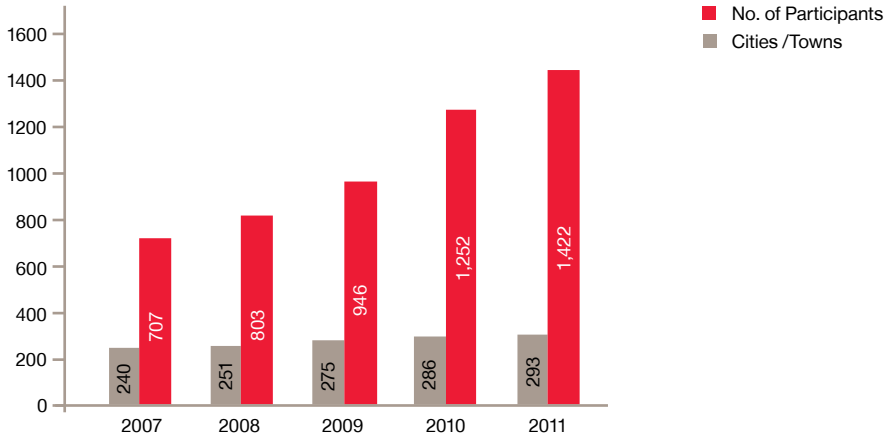
Around 90% of the liquidity in Indian capital markets comes from around 10 cities and 100 listed companies.

Dematerialisation: Quantity and Value



Source: NSDL

Number of participants offering depository services



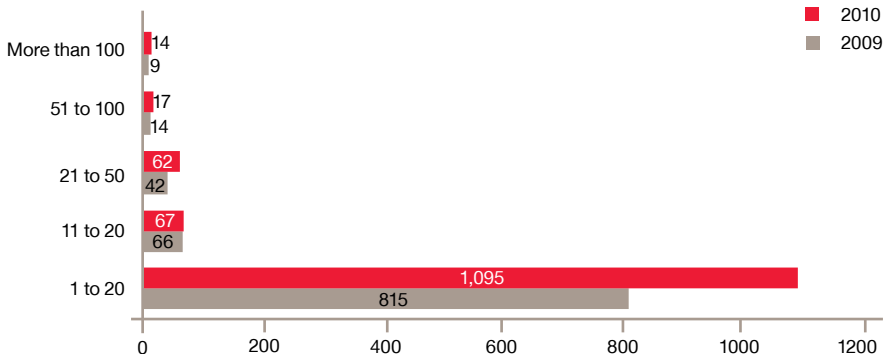
Source: NSDL

Stock exchanges have witnessed a steady rise in the number of participants offering depository services and spreading access to an increasing number of cities.

In the case of mutual funds, units of mutual fund schemes have been allowed

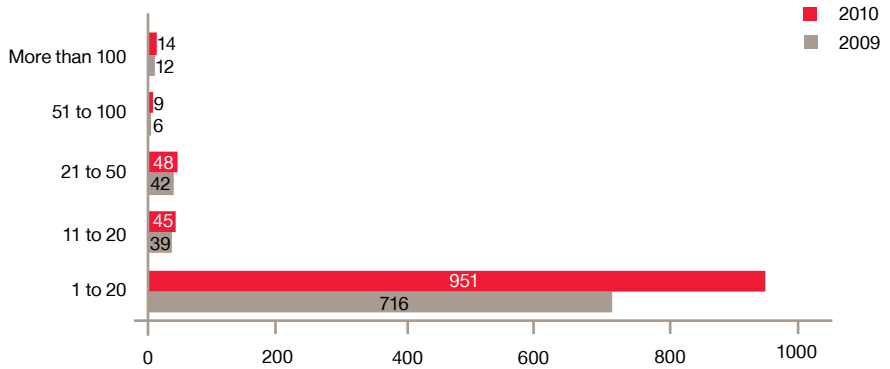
to transact through registered stockbrokers of recognised stock exchanges. This trading also proves to be a huge benefit for the investor. This mode of trading is gaining popularity, with the potential to reach out to investors in smaller towns and cities.

Geographical spread: cities as per DP locations



Source: SEBI Annual Report 2010

Geographical spread: cities as per DP locations



Source: SEBI Annual Report 2010

Domestic market: Aligning itself with global practices

In an effort to integrate trading activities in India with global capital markets, emphasis has been laid on instilling transparency and disclosure norms for the benefit of customers.

Providing the investor with all available information is one of the key aspects that the stock exchange focuses on. Volumes on the stock exchange have improved significantly over 2010, reflected in a steep rise in the market capitalisation to GDP ratio.

Ownership and governance of stock exchanges is a major area of concern and a committee has therefore been set up to address pressing concerns. These include the relationship between the stock exchange and the clearing corporation, the relationship between the stock exchange and technology providers.

Technology: Adding speed and efficiency to the market

Speed and security outline the basic premise of the functioning of capital markets in today's changing environment. The need for enhanced speed, coupled with spiralling data volumes across the market has forced industry players to take a keen look at their IT and business process strategies.

In the current business environment, information technology has the ability to provide customised solutions to deliver a unique value proposition to customers. Technology can help financial institutions enhance value, improve margins and increase efficiency manifold.

As technology matches its steps with change, IT solutions proliferate to the

business, making operations and processes more efficient and re-engineering customer response techniques. Technology offers a suite of services that include turnkey solutions, offshore development centres, customised products, business process outsourcing and most importantly, infrastructure management.

Technology tools need to be roped in by banks, brokerage firms, exchanges, settlement houses, investment management firms, investment services companies and financial services

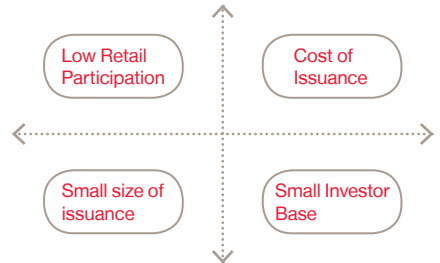
An exchange data centre has been formulated to lend support to the increasing volume of traffic in trading. It seeks to provide an efficient electronic trading platform to investors, increasing speed of execution, market data dissemination and improving risk management.

The debt market in India: Waiting to take off

The debt market in India, especially the corporate bond market, is yet to establish a firm foothold in the Indian capital market. There is huge potential for expansion in debt markets with investment demands for infrastructure ever increasing. Some challenges that have prevented bond markets from picking up the pace characteristic of equity markets are illustrated below

A well developed bond market is the key to economic growth, enabling long-term

financing of infrastructure, housing and private sector development. The debt market in India remains under-



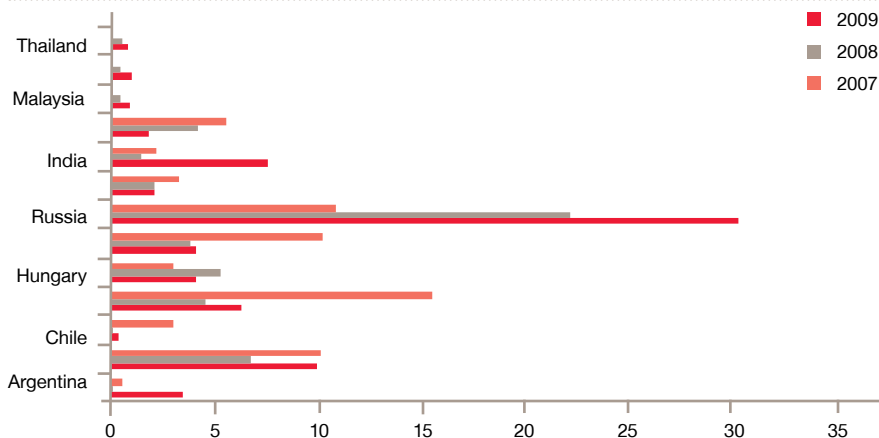
penetrated with very low participation from the retail sector and efforts need to be channelised in educating and creating awareness among investors.

In spite of a well-developed regulatory and financial system, the corporate bond market in India is only 3.3% of GDP. In contrast to a mature equity market, the bond market in India is relatively under-developed as compared to other Asian economies and developed nations.

The share of corporate bonds to GDP is 10.6% in China, 41.7% in Japan & 49.3% in Korea.

Favourable interest rates in India have succeeded in drawing funds from foreign investors in the corporate debt market, with participation from mutual funds and other investors for a short term of one to three years has also picked up. Another boost to trade has been a mandate by SEBI which mandated that all trades in corporate bonds would have to be cleared and settled by a clearing company to eliminate counter-party risk and increase liquidity.

Bond issuance in Emerging markets (in US \$ bn)



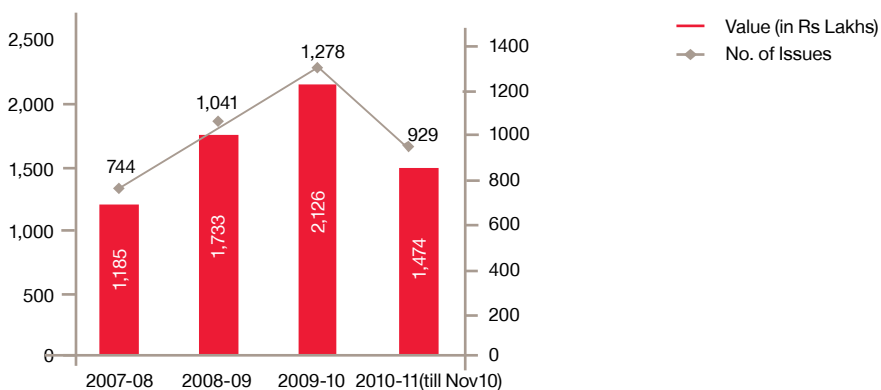
Source: Economic Survey 2011-12

Till then, mutual funds or foreign institutions would trade in corporate bonds directly or through a broker without reporting to regulators.

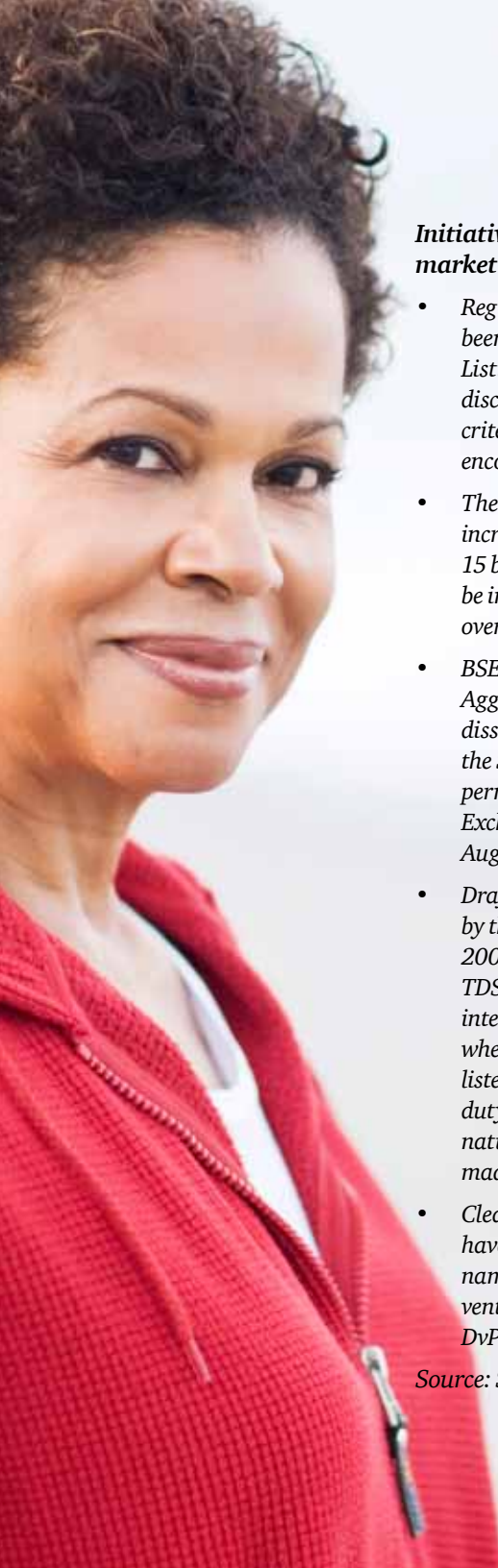
Data released by SEBI indicates that companies raised ₹ 21.3 crore through corporate bonds in 2009-10, up 22.7% from ₹ 17.3 crore in 2008-09.

Although the year has seen a number of public issues, private placements have remained one of the preferred modes of raising debt funds. The rise in funds mobilised could also be attributed to issuers preferring domestic debt markets as a primary source of corporate debt.

Private placement of corporate bonds



Source: Economic Survey 2011-12



Initiatives for developing the Indian corporate bond market

- *Regulatory jurisdiction over the corporate bond market has been clearly defined and placed under SEBI. SEBI (Issue and Listing of Debt Securities) Regulations, 2008 simplified disclosures and listing requirements. A minimum market criterion has been reduced from ₹ 10 lakh to ₹ 1 lakh to encourage retail investors.*
- *The limit of FIIs investment in corporate bonds has been increased to USD 20 billion from the existing limit of USD 15 billion and the incremental limit of USD 5 billion has to be invested in corporate bonds with residual maturity of over five years.*
- *BSE, NSE and FIMMDA have set up reporting platforms. Aggregate data reported on these platforms is disseminated to the public. Summary data is available on the SEBI website. Repos in corporate bonds have been permitted, following RBI guidelines, since March 2010. Exchange traded interest rates futures were introduced in August 2009.*
- *Draft Credit Default Swap (CDS) guidelines were released by the Reserve Bank of India in July, 2010. The Finance Act, 2008 (with effect from June 1, 2008) mandated that no TDS (tax deduction at source) would be deducted from any interest payable on any security issued by a company, where such security is issued in dematerialised form and is listed on a recognised stock exchange in India. The stamp duty on items in central list (debentures and bonds in the nature of promissory note) have been brought down and made uniform.*
- *Clearing and settlement through clearing corporations have been mandated for trades between specified entities namely mutual funds, foresight institutional investors, venture capital funds etc. Clearing and settlement is on DvP I basis.*

Source: SEBI

Thus, the corporate bond market needs to be developed in order to fund long-term infrastructure requirements. Some of the initiatives already undertaken are mentioned below along with other measures that we believe may be necessary for the growth of this market.

Corporate Bond Market: Our Recommendations

- *Widening of investor base*
Increased participation is critical to growth, catering to investor requirements and enhancing liquidity in the market. This should result from investments by banks in corporate bonds. FII investments need to be encouraged as they contribute huge volumes to the corporate bond market, thereby increasing liquidity. Also, avenues should be opened up to co-operative banks, allowing them to invest in quality corporate bonds.
- *Abolition of tax deducted at source*
Tax deducted at source is detrimental to the development of the bond market. A possible solution could be the adoption of a tax regime in the case of government securities or equity shares.
- *Product innovation*
Debt funding in India is primarily sourced through banks. To help banks manage their portfolio efficiently, it is essential to enable the secondary trading of loans.
- *Infrastructure financing through debt:*
A long gestation period of infrastructure projects leads to a need to create specialised long-term debt funds. Infrastructure-focused debt funds will enable banks to participate in funds, allowing increased volumes of debt financing from banks to be deployed towards development of infrastructure.
- *Credit derivative products*
The derivatives market in India is under-developed. Moreover, absence of products for hedging credit risk also acts as a deterrent to investors. There is a need to have a market for better price discovery and hedging.
- *Increased Retail interests*
The retail segment has shown very little interest in government securities, on account of small savings instruments and also the incumbent challenges in accessibility. To encourage small investors, the bond market structure should align itself with the equity market model.
- *Regulatory reforms*
Regulatory reforms will impact the development of the corporate bond markets on two aspects
 - Restriction on investment for various investor classes
 - Pension funds and new pension reforms

Derivatives market: Mobilising resources

Exchange traded derivatives form an important segment of Indian stock markets. Trading in derivatives is dominated by NSE, which has a share of over 99% of the total turnover. Over the years, the derivatives market has generated a turnover which is extensively higher than that of the equity segment.

The total number of contracts traded in the derivative segment of NSE rose marginally by 3.4% to 67.9 crore in 2009-10 from 65.7 crore in 2008-09, whereas, at BSE, the number of contracts traded declined substantially from 4,96,502 in 2008-09 to 9,026 in 2009-10. The value of the contracts traded in the derivative segment of NSE increased by 60.4% to ₹ 1,76,63,665 crore in 2009-10 from ₹ 1,10,10,468

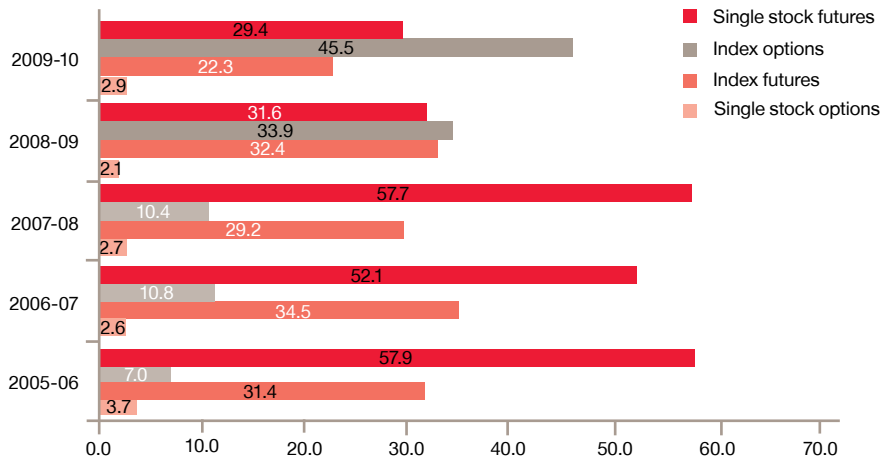
crore in 2008-09, whereas the turnover at the derivatives segment of BSE declined to ₹ 234 crore in 2009-10 from ₹ 11,775 crore in 2008-09.

Index options are seen to have the highest share of the turnover, with a share of 45.5%, with single stock options holding a nominal share of 2.9%. Index options have steadily grown over the period 2006-10 to claim a higher share of the total derivatives turnover, crowding out the share of Index futures and single stock futures.

Heralding the Next Big Thing: Commodity Derivatives Market

The commodity derivatives market in India is just coming out of hibernation. The current phase of consumption-led economic growth implies a growing demand of commodities. This necessitates the use of commodities

Product-wise derivative turnover at NSE and BSE (in %)



Source: SEBI Annual Report 2010

derivatives and derivatives exchanges for increasing market efficiency and true price discovery. Equity market movement is influenced by domestic and global growth, expected corporate performance, changing political environment and expected policy changes. Commodity markets often act as a defence to the fall-out in the above areas as well as in expected changes in commodity output, agriculture and weather. However, in India, FIIs play a dominant role and like the equity market, can influence the commodity market also. The current surge in commodity markets needs to be viewed in the right context.

The emerging need for trading in commodity derivatives is the result of investors wanting to trade at minimal costs with efficiency. The commodity exchange eco-system is expected to evolve to meet these requirements.

Commodities are widely consumed by a variety of segments from industrial to retail. As the participating segments in a commodity's lifecycle increase, the necessity to hedge the risks associated with the commodity also increase. Commodity derivatives present an opportunity for all participants to simultaneously hedge their commodity risks. Additionally, the high levels of equity markets have made investors looking for higher returns view alternative asset classes such as

commodities, thereby fuelling speculative interest in the asset class.

As the market evolves, growth is expected to change the product composition. Metals trading accounts for the bulk of Indian commodity derivatives. But going ahead, as newer commodities become permissible, the composition of derivatives traded is expected to change. The commodities space is going to become much more dynamic than it has ever been.

- *Exchange based trading in commodities is expected to rise in the near future*
- *Newer entrants in the exchange space will fuel further competition*
- *Newer products traded on the exchange will bring-in 'first-time' traders as well as experienced global players*
- *Increasing trade will incentivise brokers to further increase market penetration*

Increasing Penetration: Product Innovation



The savings rate in India is high, at around 33.7% prevalent even in the rural and semi-urban areas. The incumbent challenge encountered in these areas is lack of awareness about the diverse range of financial products available for investment. This segment of the population invests primarily in traditional assets like gold and land, and it is these investments that need to be

channelised into appropriate investment avenues.

The deregulation of the financial services industry and increased competition has created the need to design new products, develop better processes and implement an effective solution for increasingly complex financial problems.

Instruments of change

The term ‘financial inclusion’ assumes a varied significance for different financial institutions, whether banks or mutual funds. For banks, the term signifies bringing the un-banked population under the financial services net, while for mutual funds, financial inclusion aims to increase access to mutual fund products channelising savings into appropriate product schemes based on risk profiles.

Capital markets have immense potential to drive the agenda of financial inclusion by providing investors with the opportunity for wealth creation. Products and services need to be tailored to suit the requirements of the investor in terms of risk appetite and expected return. To design these products suitably, it is necessary to lay the foundation of financial literacy and draft proper customer segmentation. A low-cost distribution mechanism is required, ideally.

Apart from being looked upon as a social responsibility, financial inclusion also presents a huge business opportunity, capable of spearheading growth in the financial services space. However, to turn this agenda of inclusive growth into a viable business model, it is imperative to make use of technology, without which increased participation from masses cannot be sought.

Online banking, online distribution of mutual funds, mobile banking, etc are some of the emerging areas in the financial services industry. These claim to increase efficiencies, speed of transaction and add to the customer’s convenience.

Hedge funds, private equity funds and pension funds as compared to mutual funds, insurance and fixed deposits are providing increased exposure to investors

Popular products in the west like LEAP, FLEX options contracts encourage the existing options market

NBFCs have the advantage of wide distribution networks in rural areas and are therefore well placed to secure mass participation in financial products. Therefore, the NBFC segment deserves more attention today. Apart from optimising their strength in distribution, their ability to introduce innovation in products and then map a distribution model for it is quite immense. They also follow a focused approach to deal with the dedicated business model and ensure that it remains within the estimated budget.

The technology platform with the capability to fast track financial inclusion is that of mobile communication and the internet. Internet stock trading is popular among retailers, with India reported to have 70 million to 80 million internet users and around 5.2 million broadband internet connections.

However, internet penetration is a mere 7% as compared to 31% in China, 64% in Malaysia, 26% in Thailand and 77% in the United States, implying a great potential for internet trading.

Mobile telephony is a channel to broaden the financial market base, which already has more than 800 million subscribers. In the near future, a mobile trading revolution is likely to lead the agenda of financial inclusion.

Some of the outreach measures adopted by banks and MFs are as follows:

Recent initiatives include the following:

- “No-frill” account for retail purpose
- Simplified Know Your Customer (KYC)
- Credit counselling centre (GCC) facilities
- Use of NGOs and formation of SHGs (Self-help groups)
- Kisan credit cards services and
- Extension of smart cards.

The Rangarajan Committee also spelt out priorities for meeting the financial inclusion objectives. Their reach potential can be immense, especially in combination with the banking correspondence (BC) approach.

As part of the investor education initiatives, SEBI has launched many programmes over the last one year by organising seminars, workshops, investors’ meets, etc. The regulator has also introduced financial literacy programmes in school curriculum in collaboration with NISM.

The FMCG industry showcases an exemplary distribution model, claiming to have a high penetration rate in rural and semi-urban areas. Banks can tap into this pool of customers and realise huge opportunity in terms of access to capital as well as generation of savings.

Providing Resilience: Corporate Governance



Corporate Governance and Promoters Ownership

Good corporate governance practices are a reflection of the integrity and credibility of capital market players. Transparency and disclosure norms, by way of effective corporate governance practice, lay the foundation for a robust and resilient financial system to gain investor confidence in the financial institution. In principle, corporate

governance is about managing the relationship between shareholders, the board and other stakeholders.

To implement strong governance practices, the financial system needs to be supplemented with competent risk and control functions. The risk management function should be supported with adequate authority and independence. Over time, this should

become an ongoing process aimed at identifying and monitoring internal control infrastructure.

Institutionalisation of risk management is of prime importance to sustain growth in the long run.

Corporate governance has received focussed attention in recent times since the debacle of Enron and Worldcom. The Cadbury Committee Report laid the foundation of discussion on corporate governance in the 1990s. In India, the debate began with the release of the Kumar Mangalam Committee Report.

Subsequently, various efforts have been made by the government and other regulators to improve governance standards. Yet, it remains a concern for capital market participants, particularly the investors.

In most cases, fund managers and investors are not confident about the extent and quality of the governance system. Structural issues need to be addressed to put in place an efficient board. True independence of the board, separation of responsibility (policy and strategy responsibility of the board and implementation by the corporate management team headed by the CEO), structured selection process (independent and promoters), designing a format of responsibility and liability of board members and all issues of critical concern for long-term investors.

What does it mean for Financial Institutions?

- *Setting strategies and objectives*
- *Determining risk tolerance*
- *Protecting the interests of depositors and meeting shareholder obligations*
- *Aligning corporate activities in compliance with laws and regulations*

Rating corporate governance practices in a company with the help of a special agency for this purpose can be a possible solution to these issues.

Some challenges that governance encounters include complex ownership structures and lack of transparency. The corporate objective of an institution may get diluted if insiders and controlling shareholders exercise undue pressure on its activities.

Corporate ownership of equity is another issue with significant impact on corporate governance practices and investors' decision. Excessive control of promoter and promoter-related companies with huge voting rights may directly or indirectly influence corporate control and may negate good governance practices. Investors look for

Steps to mitigate the settlement risks of products:

- Establishment of a Credit Guarantee and Investment Mechanism (CGIM) has been seen as an initiative to render credit guarantee for bonds issued by the corporate sector.*
- Complex financial products like hedge funds, private equity funds, derivatives and asset-backed securities should be closely monitored in areas of distribution, trading and compliance with regulations.*

well managed companies with a track record of good corporate governance as well as widely held companies with substantial public holding.

In order to reduce excessive promoters' control over a company in terms of equity share holding, the government proposed minimum shareholding of 25% by the public. Some studies show that by the end of March 2010, there were 227 companies with more than 75% of promoters' shareholding—among them 39 PSUs, 29 foreign companies and 159 other Indian companies.

However, experts say that 25% holding seems to be quite low and with 75% promoters' holding, promoters may end up adversely impacting corporate governance practices. This may prove detrimental to the interest of investors.

Shareholder rights are essential to protect the investor from poor

management. Protection of shareholder rights, especially minority shareholders, is a challenge for developing and implementing effective corporate governance.

The supervisory board in a financial institution needs to periodically review organisation rules, ensuring that practices are regularly upgraded. Further, public disclosure should get desired attention with relevant and updated information provided to supervisors to avoid conflict of interest.

In the case of mutual funds, fund houses disclose their policies and procedures for exercising voting rights with respect to shares held by them, on the website and annual report of the respective AMC.

Governance should ultimately aim to propel growth, and correct market failures when they arise.

Challenges to governance

While India has undertaken numerous reforms in corporate governance over the last decade, especially in the area of company boards, independent directors and disclosure and accounting standards, certain critical areas remain to be addressed—particularly relating to the accountability of promoters (controlling shareholders), the regulation of related party transactions and the governance of the audit profession.

Reforms are sorely needed in these areas in order to strengthen the integrity of India's capital markets and to realise its goal of becoming an international financial centre.

Some of the most pertinent challenges in the way of impactful corporate governance are as follows:

- **Shareholder meetings and voting**
Shareholder meetings in India lack efficiency and accountability.

Other Challenges

- *Capacity constraint on the part of the regulator*
- *Dealing with enforcement of corporate governance measures*
- *Limited awareness of shareholders about their capacity to intervene in company affairs*
- *Costs associated with adopting a new accounting regime*

Voting procedures need to incorporate best practices and accommodate the emerging global interest in nature of share ownership.

Reliability of these shareholder meetings should be ensured and informed voting decisions should be made. Also, proxies should be allowed to speak at meetings, and the voting results should be published on the website.

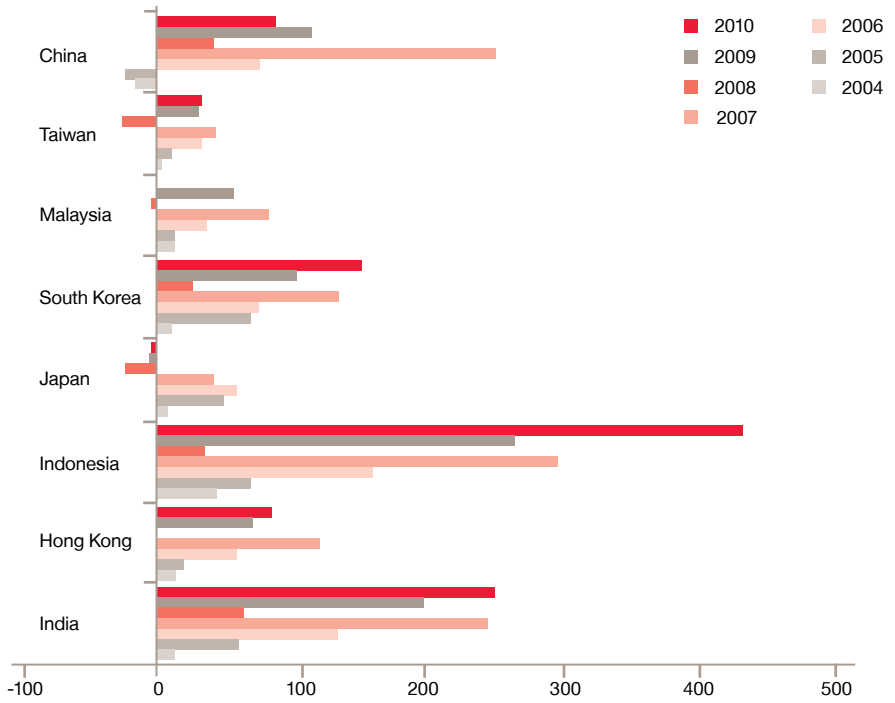
Drawing Investor Attention: Emerging Capital Markets



Asian markets by and large, have been the hub of trading activity, luring funds from global investors. Here is a comparison between the Indian stock exchange and other emerging

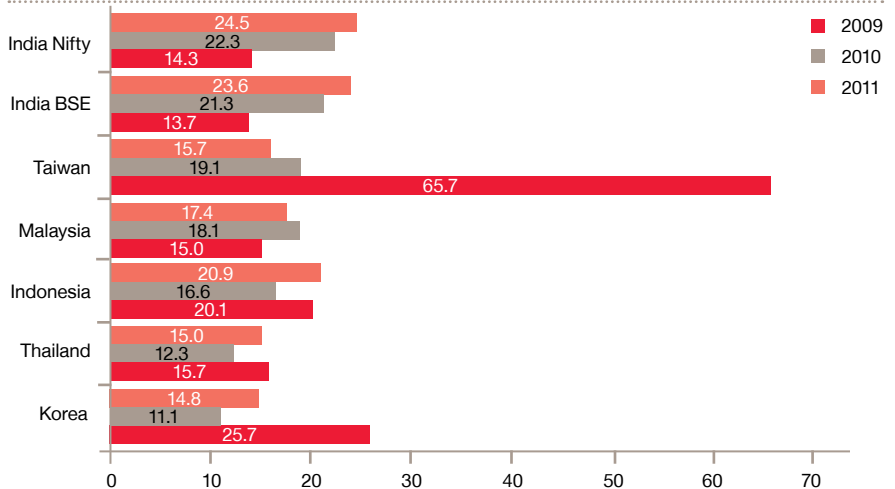
economies. The movement of global indices, vis-a-vis, that of India is also portrayed to benchmark the performance of Indian stocks.

Movement of Global Indices (%)



Source: Economic Survey 2011-12

P/E ratios in select Emerging markets



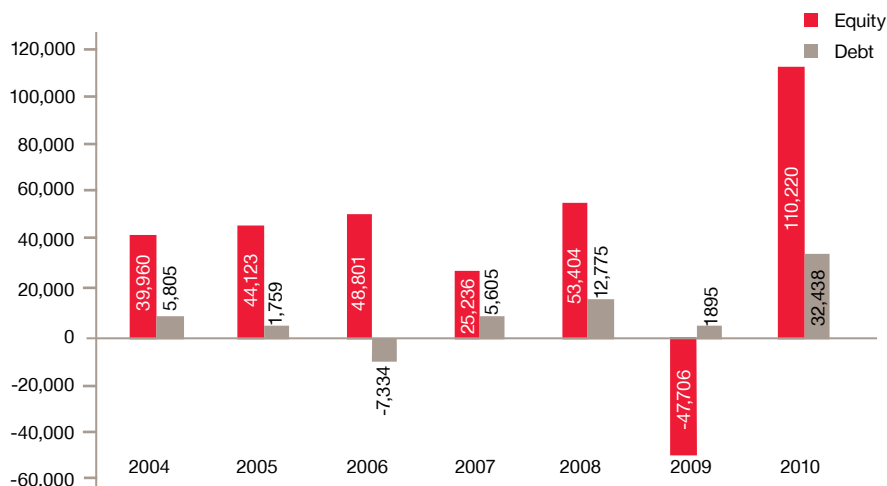
Source: Economic Survey 2011-12

FII's have been investing into India at a steady pace, with funds flowing into capital markets. The number of registered FII's increased from 1,713 on 31 March 2010 to 1,718 as on 31 December 2010. The number of registered sub-accounts also increased from 5,378 to 5,503 during the same period.

In the Indian equity market, FII's invested ₹ 1,12,622 crore during 2010-11

(as on 31 December 2010) as compared to ₹ 1,10,221 crore in 2009-10. Further, in the debt segment, FII's invested ₹ 24,839 crore in 2010-11 (as on 31 December 2010) as compared to ₹ 32,438 crore in 2009-10. So far during 2010-11, total investment in equity and debt by FII's stood at ₹ 1,37,461 crore as compared to ₹ 1,42,658 crore in 2009-10.

Net investment by FII's (in ₹ crore)



Source: SEBI Annual Report 2010

Foreign investors have purchased stocks and bonds worth over ₹ 79,000 crore from the Indian capital market as of January, 2011. On the other hand, FIIs have sold shares and bonds worth ₹ 72,910 crore, resulting in a net investment of ₹ 6,509.60 crore.

As on January 2011, overseas investors have been gross sellers of equities worth ₹ 4,220 crore, and showing a positive outlook on the debt market, made a net investment of ₹10,730 crore. In 2010, foreign investors bought stocks and bonds valued at nearly US\$ 221.34 billion, a record number in a year. Net FII investments as on March 29, 2011 were recorded at US\$ 1.13 billion.

These statistics affirm that investor confidence remains strong in the India growth story.

In 2010, FII investment into India was 57% higher than in South Korea, which remains second in terms of overseas investment followed by Indonesia, Taiwan, Thailand, Philippines and Vietnam.

A new survey of 45 institutions—including central banks, sovereign wealth funds and pension funds in Asia and Europe managing aggregate assets worth \$1.6 trillion (₹ 72 trillion)—by Fidelity and Greenwich Associates, a consulting firm, indicates that China and India remain favourite investment destinations for global investors.

Of the investors surveyed, 11% planned to raise allocations to China and 9% to India in three years. Currently, 24% of these investors have allocations to China and 13% to India, and none intend to discontinue these allocations.

Even recently, Indian markets outperformed their global peers showing resilience, as other regional markets recover from the repercussions of the earthquake- and tsunami-devastated Japan.

Government measures; Providing an added boost

Focusing on infrastructure development while deepening the corporate debt market, the government has raised the FII investment limit in corporate bonds from US\$ 20 billion to US\$ 40 billion. The additional limit of US\$ 20 billion will be available to FIIs only for investments in corporate bonds issued by companies in the infrastructure sector.

SEBI has announced revised reporting formats for FIIs on their Offshore Derivatives Instruments (ODIs), which include Participatory Notes (PNs). ODIs have Indian equity or debt as underlying securities and are issued by registered FIIs or sub-accounts to clients abroad.

Starting April 2011, reports providing details of ODIs or PNs activity need to be filed.

A Regulatory Snapshot of the Indian Capital Markets



Development of capital market cannot be complete without a robust regulatory environment attempting to keep pace with innovation in the market. Over the past period, SEBI has introduced various changes in the regulatory framework for the capital market and few such key developments during the recent past months are as under:

- *Introduction of derivative contracts on foreign stock indices*
Permitting stock exchanges to introduce derivative contracts (futures and options) on foreign stock indices in the equity derivatives segment for Indian resident subject fulfilment of specified eligibility criteria and conditions.

- *European-style stock options*
Providing flexibility to stock exchanges to offer either European-style or American-style stock options. SEBI has laid down guidelines for a stock exchange interested in introducing European-style stock options instead of American-style stock options subject to compliance with other conditions like contract specifications, risk management framework etc.
- *FII's Permitted to Make Investment in Primary Debt Issues*
Permitting FII investment in primary debt issues subject to the condition that the debt issue listing must be done within 15 days.
- *Allocation of government debt And corporate debt investment limits to FIIs*
Current limit of FIIs investment in government securities and corporate bonds (issued by infrastructure companies as definition provided in the External Commercial Borrowings (ECB) Policy), with residual maturities of over five years, by US\$ 5 billion respectively has been increased which shall be allocated (along with unutilised limit) through a bidding process on a first-come-first-served basis.
- *Systemically important non deposit taking nbfc's (NBFCs-ND-SIs) permitted to participate trade in currency options on exchanges for hedging forex exposures*
With a view to extending the facility of exchange-traded hedging tools to NBFCs, NBFC-ND-SIs have now been permitted by the RBI to participate/trade in currency options exchanges recognised by SEBI as clients, in order to hedge their underlying forex exposures subject to compliance with relevant RBI guidelines issued by the Foreign Exchange Department and appropriate disclosures.
In addition to various changes proposed by SEBI in the regulatory framework of the Indian capital market, SEBI has also introduced certain developments in the reporting requirements for different players of the capital market for ensuring increased transparency in the markets. Few of such key developments during the recent past months are as under:

- *Reporting of OTC transactions in certificate of deposits (CDs) and commercial papers (CPs)*
All SEBI-regulated entities shall report their OTC transactions in CDs and CPs on the FIMMDA reporting platform within 15 minutes of the trade for online dissemination of Amarket information.
- *Reporting of offshore derivative instruments (ODIs)/ PNs activity by FIIs*
In addition to changing the formats for reporting issuance/ renewal/cancellation/redemption of ODIs/PNs by FIIs against underlying Indian securities, SEBI has also made it mandatory for the FII to provide an additional undertaking that the concerned FII is the beneficial owner and the person to whom the ODI is issued. As a part of this reporting, FII has to provide information with respect to 'end beneficial owner' of the ODI as against the person to whom the ODIs were issued.
- *Foreign institutional investors to submit declaration and undertaking about their structures*
It has become mandatory for all the registered FIIs to provide declaration and undertaking about their structure to SEBI by 30 September, 2010, failing which they shall not be allowed to take fresh positions in cash and derivative markets with effect from 1 October, 2010, while they can retain their current positions or set-off/unwind.
It can be noted that while SEBI has broadened the Indian capital market by introducing various new developments, it has also ensured better transparency in the system by refining the existing reporting system and introducing further mechanism for monitoring the relevant information. In future, standardising and harmonising the regulatory norms will help India position itself prominently on the global pedestal.

Regulatory Developments in the US Capital Markets



The investment banking and broker/dealer environment is fraught with challenges. While the stock markets regain confidence, performance improves and M&A activity accelerates, there has been a decline in fixed income, currency and commodities activities. Capital markets are restructuring their business models to deal with regulatory reforms, and financial institutions are

impacted in varying degrees by the introduction of clearing houses for plain vanilla swaps, increased transparency of derivatives, limited hedge fund and private equity fund ownership and requirements on retaining credit risk on securitisation.

Some of the key developments in the US market are as follows:

- *Commodities, futures and derivatives reforms*

The Commodities Futures Trading Commission (CFTC) has been striving to keep up with the rulemaking required under Dodd-Frank. The CFTC has already met several times to discuss the implications and implementation of the Dodd-Frank rules. Some of the proposals that have emerged have been criticised for going beyond the original intent of Dodd-Frank and could increase the cost of risk management, while reducing liquidity in US markets by pushing activities abroad.

- *New round of stress-testing for banks*

The Fed ordered the 19 largest financial institutions in the US to re-examine their capital levels against a hypothetical recession in which unemployment levels reach 11% and GDP contracts by 1.5%. The outcome of this exercise will help determine whether the Fed will allow banks to increase their dividends and conduct share repurchases.

- *Broker/dealers face proposed fiduciary responsibility*

The 5,100 brokers/dealers registered with FINRA (Financial Industry Regulatory Authority)

are currently governed under principles of fairness and transparency, but are not subject to the fiduciary responsibilities of investment advisors. Brokers/dealers generally earn transaction fees and do not have to disclose potential conflicts of interest or determine the suitability of an investment recommendation. This difference in the standard of care between broker/dealers and investment advisors has led to confusion among clients. The Dodd-Frank Act recommends establishing a uniform fiduciary standard for both professions.

The proposed change has been criticised by SIFMA (Securities Industry and Financial Markets Association) as being overly broad and failing to create a compliance structure for various parties serving the same client. Brokers/dealers are likely to switch to new asset-based advisory fees to replace the commissions and spread-based structures that currently determine compensation. This will likely increase trading costs for customers while limiting investment options and alternative vehicles.

Challenges for Indian Capital Markets



- *Deepening of capital markets:* Increased penetration of capital markets is imperative for growth in the long run. With increasing needs of infrastructure funding, there is a need to focus on the development of the bond market, seeking more participation from both retail and institutional investors. Further, most of the

trading volume is dominated by the metro cities; 10 cities contributed over 80% of the trading volume in 2010, as per SEBI.

- *Limited awareness about financial instruments:*

One of the typical challenges that the Indian markets are faced with is that of channelising the savings into the appropriate investment avenues. Investors possess limited knowledge and information on products, their benefits and risk attached, which acts as a deterrent to investment. Financial literacy and easy availability and accessibility of information need to be streamlined.

- *High trading cost:*

Cost of trading is high in India and compared to other countries investors pay a high transaction cost. It is in this instance when technology needs to evolve and play a critical role in reducing costs

- *Risk management:*

The changing environment has created the need to scrutinise the existing models and methods of risk management to ensure stability and resilience. Moreover, integration with global markets signifies increased emphasis on international standards of compliance and risk management.

- *Lack of product innovation:*

The challenge in this field is to balance viability with innovation in the financial services sector. The right blend of technology needs to be used to ensure the product delivers to its optimum. Innovative offerings will also provide the opportunity to tap a larger pool of savings.

The Way Forward



Increasing participation from domestic and foreign investors

Rising incomes coupled with increase in savings and investment rates in the domestic economy have led to a higher investment demand in the economy. There is a need to channelise these investment flows into capital markets to yield returns.

New products

Emphasis needs to be laid on product innovation within a sound regulatory and supervisory framework. Focus on development of the derivatives market can help investors hedge against financial risk.

Deepening of the bond market	Global integration of markets
<p>Higher participation needs to be encouraged, by whetting the appetite of investors as well as by enhancing liquidity in the market. Investments by banks in corporate bonds need to be encouraged. The limit of FII investments also needs to be increased, as they bring in huge volumes to the corporate bond market, thereby increasing liquidity.</p>	<p>Unification of markets and integration of financial markets across product segments, use of technology and investors has led to a step forward in global integration. Deregulation, technological developments aiding cross-border mobility of funds and competitive pricing of products are some of the other factors which will strengthen the process of market integration.</p>
Inclusive growth	Regulatory reform
<p>Concerted efforts need to be made to drive the agenda of inclusive growth, encouraging more investors to access capital markets. Regulators and other industry stakeholders are driving this single-point agenda to tap the potential in smaller towns and cities.</p>	<p>Regulatory reform is required across all dimensions of capital markets, to remove structural bottlenecks. Alignment of regulations with that of international best practices will go a long way in creating a robust governance framework.</p>

Apart from the above points, in our view, globalisation has led to intense competition in the capital markets, reducing the fees charged by the stock exchange. To ensure nominal transaction costs for the investor,

competition needs to be encouraged, with entry barriers being reduced. Competition in capital markets will drive efficiency and innovation.

Conclusion



A shift in demographics, evolving consumer demands with increased customer expectations, superior technology tools, re-structuring of business models and compliance with regulatory requirements are all placing immense pressures on the financial system as a whole.

The Indian capital market, although positioned more favourably than its counterparts, is fraught with certain challenges in terms of increased access, demystifying complexities of products, identifying risk management issues and speed of regulatory reform. Operating in a dynamic business environment where stakeholders always have to be prepared to deal with uncertainties and complexities is a persisting challenge.

Moreover, the changing regulatory landscape is redefining the shape of the financial services industry.

The way forward for the Indian capital markets thus, needs to be tuned in to adapt to the constantly evolving developments in the financial services space, with a focus on product innovation and simplification, continued integration of technology with business, financial literacy and awareness, creating a resilient bond market, creating a favourable environment for FIIs and laying the foundation for regulatory reform. Emphasis on these imperatives will cement the growth path in the years to come.

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ASSOCHAM is one of the oldest Chambers of Commerce which started in 1920. ASSOCHAM is known as the “knowledge chamber” for its ability to gather and disseminate knowledge. Its vision is to empower industry with knowledge so that they become strong and powerful global competitors with world class management, technology and quality standards.

ASSOCHAM is also a “pillar of democracy” as it reflects diverse views and sometimes opposing ideas in industry group. This important facet puts us ahead of countries like China and will strengthen our foundations of a democratic debate and better solution for the future. ASSOCHAM is also the “voice of industry” – it reflects the “pain” of industry as well as its “success” to the government. The chamber is a “change agent” that helps to create the environment for positive and constructive policy changes and solutions by the government for the progress of India.

The road is long. It has many hills and valleys – yet the vision before us of a new resurgent India is strong and powerful. The light of knowledge and banishment of ignorance and poverty beckons us calling each member of the chamber to serve the nation and make a difference.

ASSOCHAM derives its strength from the following Promoter Chambers: Bombay Chamber of Commerce and Industry, Mumbai; Cochin Chamber of Commerce and Industry, Cochin; Indian Merchant’s Chamber, Mumbai; The Madras Chamber of Commerce and Industry, Chennai; PHD Chamber of Commerce and Industry, New Delhi and has over 3 lakh members.

Together, we can make a significant difference to the burden that our nation carries and bring in a bright, new tomorrow for our nation.

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The Indian firm has offices in Ahmedabad, Bangalore, Bhubaneswar, Chennai, Delhi NCR, Hyderabad, Kolkata, Mumbai and Pune.

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