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INDIA'S CAPITAL MARKETS - UNLOCKING THE DOOR FOR FUTURE GROWTH

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ABSTRACT

India's capital markets have experienced sweeping changes since the beginning of the last decade. Its market infrastructure has advanced while corporate governance has progressed faster than in many other emerging market economies. But in contrast to several developed countries and Asian economies, India's capital markets are still shallow, implying that further reforms are needed to make India a world-class financial centre. At nearly 40% of GDP, the size of India's government bond segment is comparable to many other emerging market economies. Its corporate bond market, however, remains small and is dwarfed by those of the United States, South Korea and Malaysia.

India boasts a dynamic equity market. The sharp rise in India's stock markets since 2003 reflects its improving macroeconomic fundamentals. However, the large size of insider holdings and the small presence of institutional investors belie these impressive figures. Innovative products such as securitized debt and fund products based on alternative assets are starting to break ground. But an enabling environment is not yet in place and there remains an overriding need to increase domestic investors' knowledge regarding the merits and risks of capital market investing. A vibrant, well-developed capital market has been shown to facilitate investment and economic growth. We believe that persistent reforms in the sector can support India's already impressive growth trend in the coming years.

Introduction:

Improving macroeconomic fundamentals, a sizeable skilled labour force and greater integration with the world economy have increased India's global competitiveness, placing the country on the radar screens of investors the world over. The global ratings agencies Moody's and Fitch have awarded India investment grade ratings, indicating comparatively low sovereign risks.

These positive dynamics have led to a sustained surge in India's equity markets since 2003 (see chart 1), attracting sizeable capital from foreign investors. Net cumulative portfolio flows from 2003-2006 (bonds and equities) amounted to USD 35 bn. Moreover, India's stock market has outperformed world indices in recent years. And, despite its increasing correlation with world markets in recent years (see chart 2), India still offers diversification in global portfolios.

The paper follows an analysis of supply (bonds, equities and derivatives) and demand conditions (household and institutional investors) in India's capital markets. Some stylized facts regarding India's capital market infrastructure and corporate governance are first presented, followed by an analysis of its fixed income, equity and derivatives markets. Later, the paper discusses the classes of investors in India's markets and the constraints they face in optimizing the risk/return objectives of their portfolios. Finally, some brief comments regarding the link between economic growth and capital markets reform conclude the paper.

Capital markets development supported by steady infrastructure reforms

India's financial market began its transformation path in the early 1990s. The banking sector witnessed sweeping changes, including the elimination of interest rate controls, reductions in reserve and liquidity requirements and an overhaul in priority sector lending[1]. Persistent efforts by the Reserve Bank of India (RBI) to put in place.

The introduction of electronic transfer of securities brought down settlement costs markedly and ushered in greater transparency, while "dematerialization" instituted a paper-free securities market. Together, these mechanisms eliminated forgery of share certificates. Straight-through processing automated the complete workflow (i.e. front, middle and back office and general ledger) involved in the financial transaction, thus doing away with multiple data re-entry and avoiding delays and errors. On the initiative of the Reserve Bank of India and the cooperation of public and private institutions, the Clearing Corporation of India Limited (CCIL) was established in 2001 to facilitate the clearing of trades and transactions in the foreign exchange and fixed income markets, catalyzed by the extensive use of information technology.

Good corporate governance, but overall legal framework needs improving

Continuing efforts by the SEBI to upgrade the corporate governance framework have positioned India at an above-average level against other emerging market economies, according to the Institute of Inter-national Finance (IIF), the global association of financial institutions[3]. Since March 2006, listed companies have been required to submit quarterly compliance reports to the SEBI, facilitating the valuation of companies and bringing it in line with the Sarbanes-Oxley Act.

Not with standing, enforcement remains a challenge due to a still limited number of adequately trained staff to implement the rules. Nor are companies subject to substantial fines or legal sanctions, which reduce their incentives to comply. In turn, this reflects the ongoing gaps in India's legal system, and somewhat undermines the steps to promote India's capital markets further. Although India does have a functional legal system, the country's law enforcement still lags behind the more advanced economies of Hong Kong and Singapore according to the World Bank (see chart 4). This implies that efforts to raise corporate governance need to be accompanied by a stronger

Debt markets shaped by the public sector

India's debt markets are divided into two segments. The government bond segment is the larger and more active of the two, with issuers comprising the central government – accounting for 90% of the total – and state governments. The Reserve

Bank of India (RBI) has maintained its role as the government's debt manager and regulator of government-issued papers.

The corporate bond market represents the other segment, with Public Sector Undertakings (PSU), corporates, financial institutions and banks being the primary players. PSU bonds by far outweigh the size of private corporate bonds (see chart 5), reflecting a number of factors, foremost of which are the lists of regulatory requirements for private issues. Regulatory oversight of the segment falls under the purview of the Securities and Exchange Board of India (SEBI).

Each issuer has a range of instruments available in the market (see chart 6). Since institutional investors, especially banks, have re-mined the primary participants in fixed income securities, India's bond markets have predominantly been wholesale.

Government bond issuances rule the roost

The government bond segment is the oldest and largest component of the debt market. Its size has taken off exponentially over the past decades, with the total stock of debt outstanding at roughly USD 280 bn as of June 2006[4], increasing three and a half times since 1995.

Nonetheless, the potential for the segment to pick up is promising, judging by large corporate debt being raised in the international capital markets. And the propensities to borrow are expected to grow further, arising from companies' reassessment of their capitalization. Nearly 50% of their financing comes from reinvested capital, while the rest arise from external sources either by raising equity or from bank and other financial institution borrowings.[14] Shareholders' calls for higher dividend payment and the quest to bring corporate cost of capital to optimum levels will support a rise in capital market financing in the future. At the same time, the pension fund system is moving toward defined contribution mechanism which should provide impetus to the demand for corporate bonds.

Corporate seize borrowing opportunities abroad

A more aggressive trend in overseas borrowing by Indian corporate has recently developed (see chart 16), fuelled by fewer listing requirements, lower cost of funding and better liquidity in the secondary markets. The trend also stands in contrast to the sovereign's absence in the international capital markets, reflecting the government's conservative approach to external debt management as a result of the current account crisis in 1991/1992.

Structured finance offers immense potential

Securitization is an attractive growth segment in India's debt markets. The market is still in its nascent stages, where current activities primarily occur between banks, non-bank financial institutions and asset reconstruction companies through private placements. Paving the way for a secondary market is the implementation of the proposed changes to the Securities Contracts Regulation Act, which would reclassify securitized debt as true marketable securities[17].

In terms of sectoral composition in benchmark indices, India's stock market is broad-based, putting it roughly in line with the world index (see chart 24). The higher weight of the IT sector today reflects the country's increasing turn toward a knowledge-based economy. But this may change, with consumer discretionary and consumer staples projected to get a larger share of the pie in tandem with rising incomes and as household preferences become more discerning. The shares of financials and healthcare sectors are also expected to increase markedly as industry consolidation picks up and the door to foreign direct investment is widened.

Foreign investors seize local market opportunities

Reflecting India's improving macroeconomic fundamentals, in-creasing corporate profitability and competitiveness, and greater integration with the world economy, foreign institutional investors' (FIIs) participation grew steadily over the past 3 years (see chart 25). True, FII invest in local bonds and equity, but their interest has largely been on the latter. The inflow of portfolio capital continues to test new highs and in recent years has outpaced the inflow of foreign direct investment (FDI). India's accounting standards, although still not in full convergence with international practices, combined with the quarterly reporting frequency mandated by the SEBI on listed companies, offer guidance in corporate valuation. Greater inflows are still to be expected, arising from international investors' quest for higher returns and improved portfolio diversification, buttressed by ongoing structural changes in India's economy and its financial markets. Sustained inflow of capital will not only bring greater liquidity in the market, but foreign presence will encourage further market transparency.

Overseas listing inching up

Domestic companies, both large- and small-cap, have been allowed to list abroad by way of American Depository Receipts and Global Depository Receipts (ADR, GDR) since 1992. Owing to global and local market conditions (e.g. global liquidity, stock market crashes, economic and financial crises), the amount raised through the ADR route since its inception has been quite volatile. Only in recent years have issuances picked up steadily, with the amount raised in fiscal year 2005/2006 exceeding USD 2.5 bn, a level not seen in over 10 years[21] (see chart 26). As one of the measures to allow greater capital account convertibility, the RBI has allowed two-way fungibility for Indian ADRs/GDRs. This allows holders of the instruments to cancel them with the depository and sell the underlying shares in the market. The company can then issue ADRs anew to the extent of the shares converted into local shares. This was not the case in the last decade, which limited companies' ability to access capital abroad.

Financial derivatives march ahead

While some form of financial derivatives trading in India dates back to the 1870s, exchange traded derivative instruments started only in 2000. Then, stock index futures, with the Sensex 30 and the S&P CNX Nifty indices as the underlying, began trading at the BSE and NSE. Since their inception, the basket of instruments has expanded and now features individual stock futures, and options for stock index and individual stocks.

Among the four asset classes, single-stock futures have the lion's share, accounting for nearly 60% of the turnover in the NSE's derivatives segment (see chart 28). In its relatively short life span, single-stock futures are outperforming those in other global derivatives market (see chart 29). The security largely owes its success to the timing of its introduction: it came into stream shortly after "badla", a futures-like practice which permitted traders to carry forward sizeable net positions until the next settlement period, was banned.[24] The key difference with badla is that a clearing corporation owned by the NSE guarantees the futures transaction, thereby reducing settlement risks.

The derivative instruments traded in the exchanges reflect many of the features of the underlying instruments. First, as with the whole-sale debt and equities segments, the NSE has steadily outpaced the BSE in terms of trading in the derivatives segment over the years. The NSE thus reflects the market's overall activity and sentiment.

Insurance companies, pension funds, mutual funds and foreign institutional investors (FIIs) form India's institutional investor base. Combined, their assets account for about 25% of GDP (see chart 31). This represents a significant increase compared to the mid-1990s, prior to the opening up of many of the sectors, such as the insurance industry, to competition. But, to put it in perspective, the combined size of the Indian institutional investors sector amounts to less than half of US mutual fund assets alone.

By and large, Indian investors tend to be conservative in their investment decisions, with a general preference for safe returns and capital preservation. As for large domestic institutional investors such as pension funds and insurance companies, their investment style has largely been the result of regulation.

Indian household investments: low risk, low return

The lion's share of households' total financial savings, roughly 50%, is placed in bank deposit accounts (see chart 31). The rest of the pie is spread over small savings accounts[28], at just over 10%, and a combined 25% in insurance and pension funds. Because of these institutions' conservative approach to investing, they appeal very strongly to households.

Institutional investors: Easing regulations will unlock capital market growth

Nearly 25% of households' total financial savings are allocated in insurance and pension funds, dominated by the government-owned Life Insurance Company of India (LIC) and the Employee Pension Fund (EPF). The LIC continues to hold a near monopoly of the industry, accounting for nearly 75% of the business, despite the opening up of the industry to private competition in 1999. Similarly, although mutual funds have been permitted to offer pension plans, a majority of the public retirement scheme remains under the control of the EPF. The guaranteed rate of return of 9% they offer is a strong incentive for investors to place their financial savings with the institution. Overall, just roughly 10% of the labour force is enrolled in a pension scheme. The rest of the workers rely on their families for support at old age or on their accumulated savings.

Creating more active markets with greater foreign presence

Foreign institutional investors (FII) and mutual funds are accorded considerable leeway in their asset allocation decisions in contrast to the insurance and pension fund sectors. Because they can adjust their positions in response to changes in their liquidity needs or the economic environment, they tend to set the tone in market sentiment or influence prices despite their comparatively small size.

Although efforts to welcome FIIs are encouraging, the total amount of investment limits accorded to them is still meager. Easing FII controls would accelerate the deepening and broadening of the capital markets, but this would require redressing capital account regulations aimed at preserving market stability in case portfolio positions are unwound.

Mutual funds are a viable long-term saving vehicle

The landscape of the mutual fund industry has undergone significant changes since the establishment of the Unit Trust of India in 1964, which for decades held the monopoly. By the mid 1990s, barriers to entry were gradually dismantled, allowing domestic and foreign private institutions to enter the fray. Assets under management have grown to around USD 65 bn in September 2006 nearly 10% of GDP (see chart 34), quadrupling in value since 1993. At its current growth rate, the sector's size will double over the next 10 years.

The road ahead

India's regulators have been active in seeking ways to develop the country's financial markets, and a culture of introducing greater risk management is starting to set in. The main challenge ahead is to strengthen the political will to further ease regulations in the capital markets and the limits prescribed to market participants.

India's economy is expected to benefit enormously from the process of gradual capital market liberalization. Empirical evidence has shown that emerging market economies that have heralded changes in their financial markets experienced higher growth and investment[31] (see chart 36). India is no exception, with per-capita GDP and domestic investment rising post-liberalization. Economies which pursued deeper financial market reforms, and whose per-capita incomes were roughly similar to India's prior to their liberalization periods, not surprisingly experienced even greater rewards. Drawing from these countries' experiences, India's growth potential can experience a sustained pick-up if it stays on the path of reforming its capital markets.

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