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Expediting Market Development Key to Achieving Long-term Growth Potential

Expert Take

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A decisive political mandate has raised expectations on the policy and reforms front. The finance minister has to balance fiscal prudence with the need for stimulating and incentivising growth and employment. The global economic slowdown is not helpful and geopolitical and economic risks remain elevated. Domestically, growth has slowed significantly and the health of the financial services sector also requires urgent attention.

Given this backdrop, markets have an important role to play in better intermediating savings, providing alternative sources of capital for growth and investment and improving the financial wellbeing. Market development is the need of the hour and the government and regulators should set the right tone to expedite. We need to restore balance in favour of growth and development of markets versus enforcement and regulation. We should adopt a more collaborative approach between government, the private sector and market participants in the spirit of trust and partnership.

Despite being a $3 trillion economy, with a market capitalisation of over $2 trillion, just about 2% of the population actually invests in the equity markets directly, and with mutual funds this share is below 5%. Indian household savings are currently skewed towards bank deposits. Inclusion of equities has proven long-term benefits and provides a hedge against inflation.

Simplified access to markets for retail investors based on Aadhaar verification and bank account linkage addresses all C-KYC/AML requirements, and cost of acquiring new clients could be reduced. Also, the elimination of long-term capital gains tax and providing tax incentives would go long way in improving penetration of equities.

An important channel to introduce retail investors to equities is the primary market (IPOs). Availability of good quality paper is important and PSU paper is an ideal vehicle. Further, in the listed universe, the quantity of paper available could be increased by revising the minimum free float requirement to 35% (from the current 25%), thereby improving secondary market liquidity. Listing of technology companies and MNC subsidiaries in India could open another segment for investors.

Foreign investors have been an integral part of the development of Indian financial markets. Despite significant improvement in the access for FPIs, India is still considered to be difficult market to invest in. Simplified KYC/AML requirements for entities from FATF-compliant jurisdictions with an additional disclosure of end beneficiary details if required by government and regulators would lower compliance costs and could go a long way towards enhancing portfolio inflows into India.

The minimum level of foreign holding should be raised from current 24%, providing headroom for FPI participation in Indian listed companies. Many companies have significantly higher thresholds for foreign holding.

Some of the restrictions in terms of access, execution and post-trade processes create a perverse incentive for foreign investors to trade on Indian products from outside India. A number of international venues have started catering to this demand, and the success of these venues deprives local markets of order flow. This in turn, affects the quality of liquidity for these products in India, ultimately increasing cost of execution.

Cases in point are successful product introductions on Indian equities, indices, USD-INR in Singapore, Dubai, US, and Europe. A review of underlying issues such as restrictions on forex trading, issuance of swaps on derivative exposures, lack of block deal window etc. would help address some of the concerns of international investors, consolidate liquidity of India access products within India, and help arrest export of Indian markets abroad.

Apart from FPIs, markets also need to be supportive of DIIs (domestic institutional investors). Participation of DIIs in the Indian derivative markets is minimal and limited to mutual funds.

Institutions like insurance companies, mutual funds and banks have significant ownership in equity markets. Access to the derivative markets would allow them to effectively hedge their exposure to the volatility in these markets. Necessary checks and balances could be built both by regulators and boards of these institutions to effectively manage their derivative strategy and exposure. Participation of DIIs in the derivatives markets would enhance cash market liquidity.

With physical settlement of stock derivatives, increasing the number of stocks permitted for derivatives should be expanded to the top 500 companies. This is expected to increase the liquidity in the underlying cash market for these stocks.

Beyond equities, the Indian debt market is largely restricted to institutions, even as retail participation in weekly auctions of government securities has only just begun. It is here that an integrated market infrastructure that includes both wholesale and retail segments would deepen the market for these securities, supporting the government's borrowing program on the one hand, and also providing an additional risk-free asset for retail investors on the other.

To sum up, market development has a long way to go across asset classes. We would be compromising on achieving our long term growth potential unless we expedite market development. Alternate sources of capital and hedging instruments are important for the real economy and it is critical for the new government and regulators to focus on making Indian markets deeper, broader, more liquid, cheaper and easier to access.

This would bring down the cost of capital for Indian corporates and provide an impetus to investments, employment and growth.

(The author is MD, NSE. Views expressed are personal.)